Federal Student Loan Defaults

WHAT HAPPENS AFTER BORROWERS DEFAULT AND WHY

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Executive Summary

Student loan default has attracted considerable attention from journalists and the research community over the past several years, as the Department of Education projects that more than a quarter of federal student loans to undergraduates will end up in default at some point. But less commonly discussed are the pathways that student borrowers follow after defaulting on a federal loan. In this report, we combine a comprehensive review of federal policies surrounding default with an analysis of post-default pathways using a newly constructed federal data set of student borrowers.

While default is common for student borrowers, it is far from a permanent status. Seven in 10 borrowers who default on a federal loan will exit default status within five years. Because defaulters tend to have small balances, around a third pay off their loans in full within a few years. Others resolve their defaults by rehabilitating or consolidating their loans. However, borrowers who exit default in these ways often fail to pay down their balances, meaning that default exit sometimes signifies little more than a status change. Many of these borrowers default again.

Borrowers may make progress toward paying off their defaulted loans in myriad ways. However, the terms and penalties for different default resolution methods are opaque, inconsistent, and often overly punitive. For example, a defaulted borrower whose wages are garnished sees nearly 20 percent of each payment go toward collection fees, which can total thousands of dollars by the time the loan is fully repaid. However, a borrower who exits default through rehabilitation pays collection fees of as little as $9—even if he does not actually pay down his loans after resolving the default.

As today's high rates of student loan default show few signs of slowing down, there is plenty of room for policymakers to standardize collection fees and create a single, fast process for borrowers to exit default. In the meantime, observers should reconsider the common conception of default as a permanent or catastrophic situation.

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While student loan default is a topic well covered by academic literature and the media, most of that analysis has focused on what *predicts* default with an eye toward preventing it. However, very little research looks at what happens to student borrowers *after* they default on federal student loans. Federal loans make up some 90 percent of student debt. Often, default is portrayed as a terminal status that is financially catastrophic for borrowers and entails large losses for taxpayers.[1]

A lack of borrower-level data on loan performance has made it difficult to test whether this characterization is accurate—or to understand even basic facts about what happens to loans after default. Publicly available data related to loan defaults are limited to aggregate statistics computed by the Department of Education (ED) and the New York Federal Reserve, as well as three-year cohort default rates at the college and university level. Such data are useful to assess rates of default and the characteristics of borrowers who default, such as school type and loan balance.

But the available data do not provide a picture of how a borrower's default status evolves over time. For example, there is little concrete information on how long loans stay in default, how outstanding balances change during and after default, and how federal policies to collect or cure defaulted loans affect borrowers' debts. Without this information, it is difficult to determine whether current policies surrounding default are fulfilling their intended purposes and where there is still room for improvement.

This report aims to expand the window into federal student loan defaults beyond the event of default itself. It attempts to provide the most robust look to date of what happens to student loans *after a borrower defaults and why*. Ultimately, this information should help policymakers evaluate the current set of policies related to default collections as well as pose new questions for researchers to explore.

Note that this analysis focuses on government policies, such as exit pathways, fees, and interest related to default, as well as borrower repayment behavior. It does not examine other consequences borrowers experience due to default.

The report is divided into two sections. The first section analyzes a new data set from the National Center for Education Statistics (NCES) that tracks how the federal student loans of students who began college during the 2003–04 academic year perform over the following 13 years.[2] We answer questions such as how long borrowers stay in default, what paths borrowers use to exit default, and how balances on defaulted loans change over time. The second section uses hypothetical borrower-level examples to simulate the effects of default—such as interest, fees, and penalties—that accrue on the loans. These examples are informed by the preceding data analysis and are based on extensive research into government policies for collecting defaulted loans and helping borrowers exit default.

Overall, our findings suggest that the popular impressions of borrower outcomes after default, even

among policymakers and researchers, are overly simplistic. There is no one typical path borrowers follow after defaulting on a federal student loan. While some borrowers stay in default for years, others leave default quickly. Some borrowers see their balances rise throughout their time in default, while others pay down their loans in full. These outcomes do not always correlate the way one might expect: A borrower who has exited default often has not repaid his loan (although he may eventually), and a borrower still in default is often making rapid progress toward fully repaying his debts.

Collection costs that borrowers pay in default can be large, just as the popular narrative says, or they can be minimal to nonexistent.[3] That is because the federal government has erected a complicated set of options and policies for borrowers in default. These policies are often counterintuitive and include perverse incentives for borrowers in how they resolve their defaults. Harsher penalties are imposed on borrowers who quickly repay their loans in full after defaulting than on those who engage in a lengthy, bureaucratic "rehabilitation" process but make no progress in paying down their debts. These findings suggest there is plenty of room for lawmakers to change policies governing default in order to make the process of exiting default simpler and more rational.

What Is Default?

For federal student loans, default is defined in law as failure to make an on-time payment for 270 days.[4] After a Federal Direct Loan enters default, responsibility for collecting the loan is transferred from the loan's third-party servicer to ED, which in turn notifies credit reporting agencies and assigns the loan to one of several private collection agencies contracted to recover such debts. This process usually extends the effective default point to 420 days after the borrower made an on-time payment.[5]

The collection agency may then use a number of strategies to attempt to resolve the loan's default status, either by returning it to good standing or by obtaining payments from the borrower to satisfy the debt. These collection techniques and policies to restore a loan in default to good standing are discussed in detail in the second section of this report.

The default is reported to credit reporting agencies, meaning it affects the borrower's credit score. While a borrower remains in default on a federal student loan, he also loses access to other federal student aid programs, including Pell Grants and additional loans.

The federal government continues to charge the same interest rate on loans in default. Therefore, a borrower's balance continues to grow while in default. Continuing to charge interest on a loan in default differs from the way defaulted loans are generally treated in the private market. Due to a combination of practical and legal reasons, private lenders typically do not charge interest once a loan has become severely delinquent, usually around 90 to 180 days, at which point it is "charged off," or declared uncollectible by the lender and sold to a collection agency. Generally speaking, the federal government has no parallel concept to charging off a student loan.

Default on a federal student loan is distinct from delinquency, which occurs when a borrower falls behind on payments but by fewer than 270 days. Unlike private lenders, the federal government does not charge late fees when borrowers are delinquent on their student loans.[6]

Failure to make payments also does not automatically mean a borrower will default. Borrowers can request a deferment or forbearance, statuses in which they are not obligated to make payments on the loan.[7] A borrower with a low income may also qualify to make a $0 monthly payment under the Income-Based Repayment (IBR) plan.[8]

Despite these alternatives, default is common. ED computes several aggregate-level measures that reveal the extent of default. As of December 2017, up to 8.7 million federal student loan borrowers were in default on $154 billion in loans.[9] Roughly 300,000 Direct Loan borrowers enter default each quarter.[10] ED has also projected that 26 percent of undergraduate student loan dollars issued in fiscal year 2018 will end up in default at some point, along with 8 percent of loans to graduate students.[11] Multiple defaults are also common. A research brief by the Consumer

Financial Protection Bureau found that up to a third of borrowers who rehabilitate their defaulted loans will default again within two years.[12]

Previous analyses of default have revealed that certain groups of students are much more likely to default. The most consistent predictor of default risk is completion; students who failed to complete their programs are far more likely to default than students who received a degree.[13] For this reason, default is most common among borrowers with small balances, since non-completers attended school for shorter periods and thus accumulated less debt.[14] Students who attended for-profit institutions and community colleges are more likely to default on their loans, partially due to lower overall completion rates.[15] More recent analyses have also found that African American borrowers default at higher rates.[16]

Economic circumstance appears to play a major role in driving default. Borrowers who earn less after leaving college default at higher rates.[17] However, research has also shown that some student loan defaults are not driven by the affordability of the borrower's debt.[18] Anecdotal evidence suggests that some defaults are driven by feelings of resentment toward a borrower's college and not necessarily by economic considerations.[19] Surveys also indicate that borrowers consider repaying federal student loans a low priority relative to other bills.[20] In this report, we mostly leave aside questions of what predicts default and focus instead on what comes after.

Aggregate Perspective: Student Loans After Default

Data on the pathways that student loan borrowers take after default have been scarce. But a new data set provides a look at what happens to federal student loans after default. NCES conducted the Beginning Postsecondary Students Longitudinal Study: 04/09 (BPS:04/09), a nationally representative sample of 16,680 students who began college in the 2003–04 academic year. BPS:04/09 followed up with that cohort three and six years after they began college, measuring outcomes such as completion status and credential type. NCES recently updated this data set with information on 10,890 of these students' federal loans through April 2016. It includes information on loan attributes, principal and interest balances, loan defaults, and the reasons borrowers exited default (if any). The data do not include actual payments made by borrowers, only changes in outstanding balances.

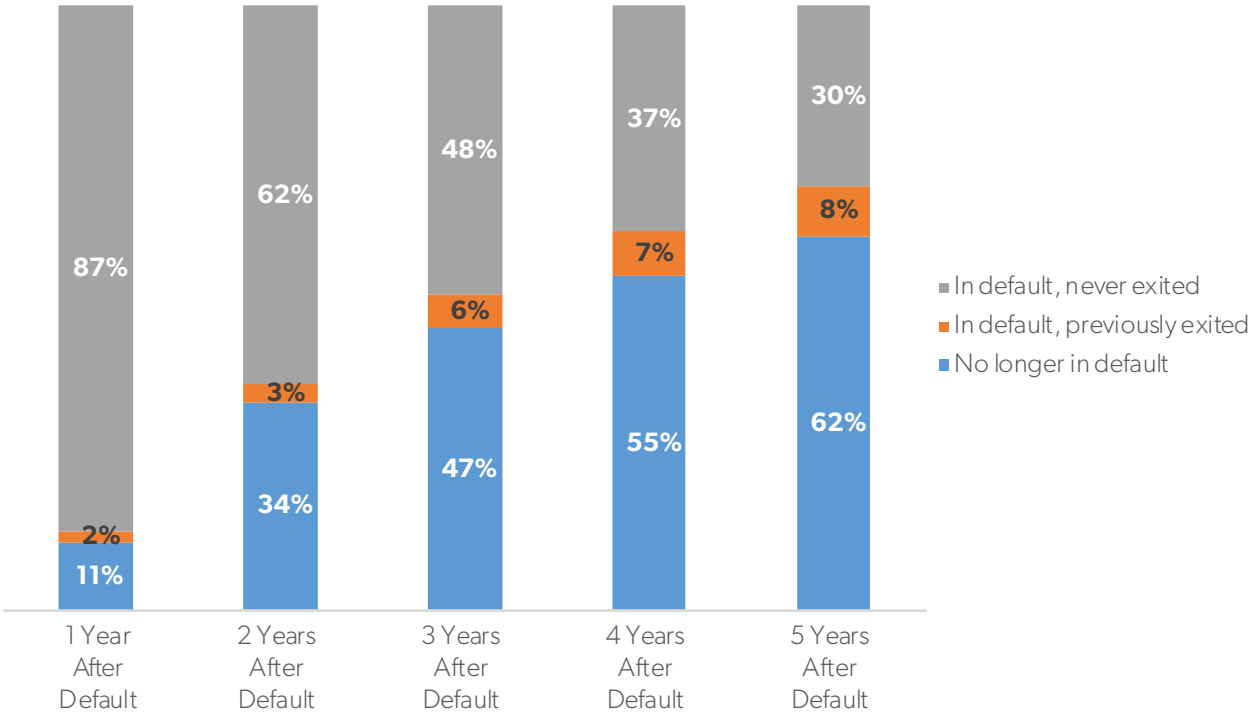
We focus on the subset of borrowers who default at least once over the study period (July 2003 to April 2016). This provides a sample of 2,670 defaulters, 1,700 of whom exited default at least once. There are also 1,580 borrowers in the data set for whom we can analyze outcomes over the five-year period following default. Regrettably, the modest size of this sample makes it difficult to conduct detailed analyses of subpopulations of defaulters. Throughout the report, we do not show any statistics based on sample sizes of fewer than 250 observations.

Aside from small sample sizes, the data set has some other limitations. Students who began college in the 2003–04 academic year may not be representative of today's college students, and defaulters in the data set may not be representative of people in default today. Moreover, the design of the federal loan program has undergone several changes since BPS:04/09 was conducted, including expansions of IBR and the elimination of bank-based, federally guaranteed loans. These policy changes may influence default behavior in ways that our analysis does not capture. (In the second section of this report, we focus on default policies in effect today rather than the policies that applied during the BPS:04/09 study period.)

Finally, this analysis focuses on three-year and five-year periods after borrowers default for the first time, but not beyond because there are insufficient data to observe repayment patterns over longer periods. Appendix A includes additional details on construction of statistics and the advantages and disadvantages of the data set.

Despite these limitations, this data set provides researchers the first borrower-level look at loan outcomes over a long period. It also allows for a more detailed look at what happens to a borrower's loans after default. The data detail when, if, and how a borrower exited default; how his loan balance changed; and even whether he entered default a

Figure 1. Default Exit Rates



Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

second time or took out more federal student loans after exiting default.

The following subsections discuss our analysis of these data and present several major findings. First, although default rates are high, most borrowers exit default within three years. Many of these borrowers, especially those with small balances, exit default by fully paying off their loans. Still others are on track to fully pay within a few years. However, many borrowers who exit default through other means, or fail to exit entirely, show no progress in paying down their balances after exiting default. Some defaulters even see their balances grow due to accrued interest, fees, and reborrowing. This is especially common among borrowers who had larger balances at the time of default. We review each of these findings below.

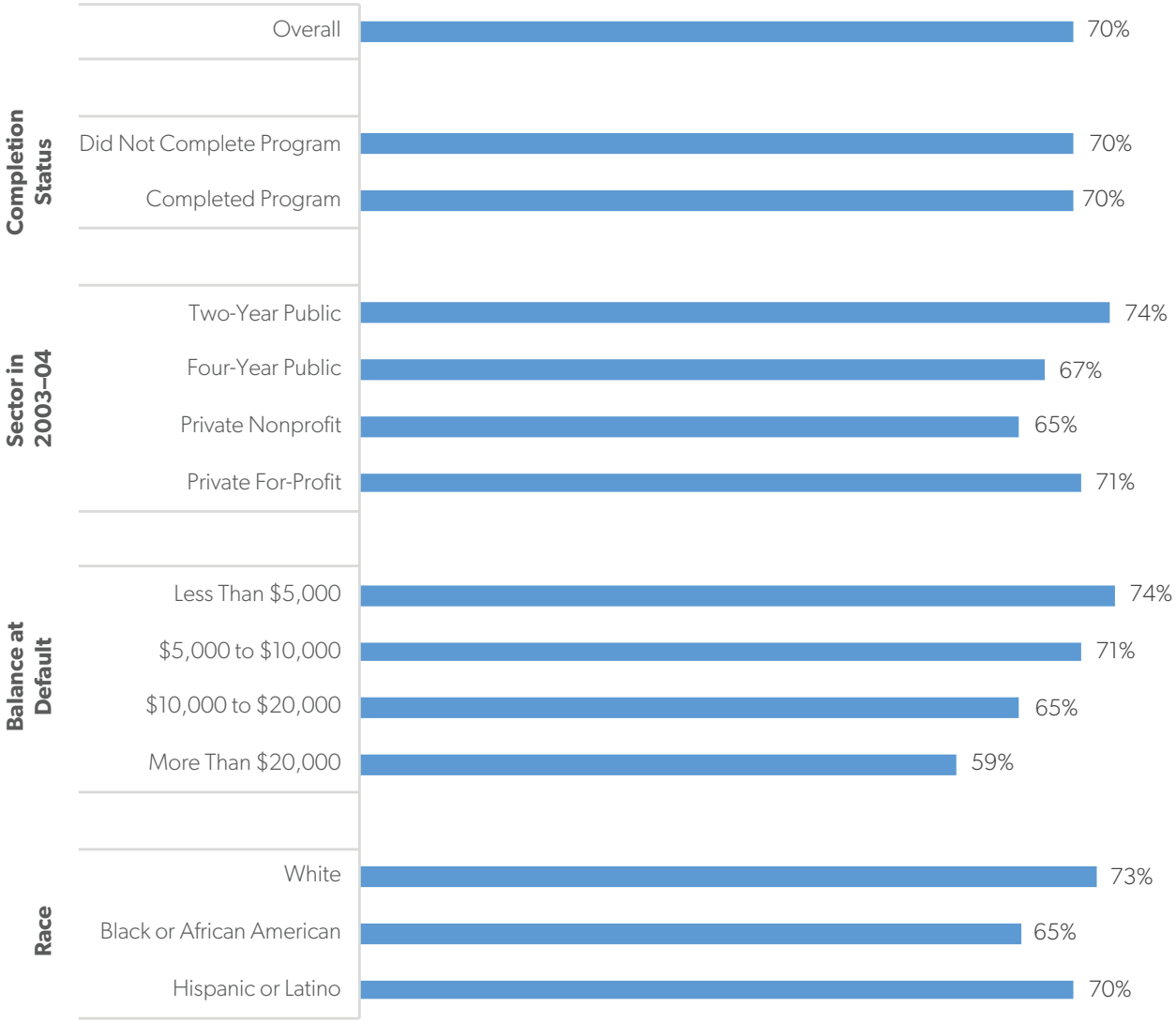
We conduct analyses at the borrower level rather than the loan level. All statistics presented refer to a borrower's first default occurrence within the study period (July 2003 to April 2016) unless otherwise specified.

Default Exit Rate. Contrary to what popular discussions often imply, defaulting on a federal student loan is far from a terminal status. In most cases, borrowers resolve their defaults by either fully paying off their defaulted loans or taking action to bring the loans back into good standing through special options the government offers (see the text box).[21]

Figure 1 shows that one year after first entering default, 13 percent of borrowers have exited, although some reenter. However, default exit rates steadily increase over time. After three years, a majority of defaulters (52 percent) have exited. Another interpretation of this statistic is that the median borrower who defaults remains in default for slightly less than three years.

After five years, 62 percent of borrowers are no longer in default on any loans. Another 8 percent are still in default, but exited at some point during the intervening five years. This means that the total five-year default exit rate is 70 percent. The remaining 30 percent of defaulters never exited. As explained later in

Figure 2. Five-Year Default Exit Rate by Borrower Characteristic



Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

this section, exiting default does not necessarily mean a borrower has fully repaid the loan or even reduced the balance.

Researchers have found that a number of characteristics predict default *entrance*. Dropouts, students who attended for-profit and community colleges, and African American borrowers are more likely to default on student loans. However, these characteristics are at best weak predictors of default *exit*. For instance, both completers and non-completers exit default at a rate of about 70 percent after five years (see Figure 2), even though completion status is one of the strongest predictors of whether a borrower defaults in the first place.

The balance of a borrower's outstanding loans at the time of default is one of the better predictors of exit. Of borrowers with less than $5,000 outstanding at the time of default, 74 percent exit within five years,

Options to Exit Default

Borrowers in default on their federal student loans have several options to exit default. We divide these pathways into "soft" exits, in which the balance of the loan is brought back into good standing, and "hard" exits, in which the default is cleared because the borrower no longer owes money on the loan. Borrowers who exit default regain their ability to borrow federal student loans. Additionally, a borrower may use a soft exit to gain access to repayment options that are not available while in default, such as forbearance, deferment, or IBR.

Rehabilitation (**soft exit**)**.** Under rehabilitation, borrowers bring defaulted loans back into good standing by making a certain number of on-time payments. Borrowers can redefault on a rehabilitated loan. This is the only option that removes the default record from a borrower's credit report.

Consolidation (**soft exit**)**.** Consolidation involves taking out a new federal student loan to repay defaulted student loans. The borrower then makes payments on the new loan, which is automatically in good standing because it is a new loan. Borrowers can redefault on a consolidation loan.

Full Payoff (**hard exit**)**.** Other borrowers may do a full payoff, in which they make payments on defaulted loans until the balance goes to zero. Some borrowers pay off their loans voluntarily, either all at once or over time. Borrowers who pay off relatively quickly may reach settlements with collection agencies to waive a portion of the amount owed. In other circumstances, full payoffs are involuntary; the federal government may use tools such as wage garnishment or seizure of federal income tax refunds (i.e., "offsets") to collect defaulted balances. Regrettably, the data do not identify how full payoffs are made.

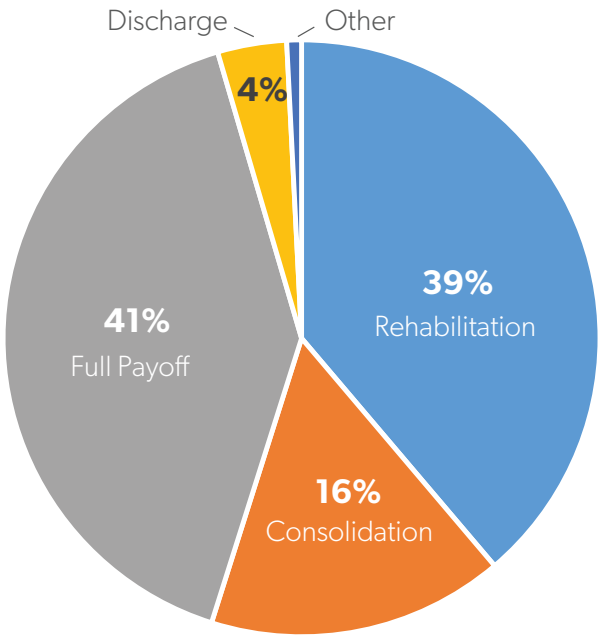
Discharge (**hard exit**)**.** In rare cases, the government discharges a borrower's federal student loans due to death, disability, or other reasons. Once a federal student loan is discharged, it is no longer in default because the borrower is not obligated to repay it.

compared to 59 percent of borrowers with more than $20,000 outstanding. This pattern makes sense because fully paying off smaller balances is easier.

Borrowers can exit default in different ways (see Figure 3). Slightly more than half of exits in our sample are "soft" exits, such as through rehabilitation (39 percent of exits) and consolidation (16 percent). Soft exits represent a change in the loan's status from default to good standing, but the borrower still owes money on the loan and may redefault. By contrast, "hard" exits end default because the borrower no longer has an outstanding balance. Most borrowers who hard-exit default do so by fully paying off the defaulted loan; borrowers may pay off the loan all at once or over time. Payments may be voluntary or involuntary, such as through wage garnishment, but the data do not identify how payments are made.[22] A small share of default exits (4 percent) are due to a discharge of the outstanding loan balance, which may happen in cases of death or disability.

Full Payoff After Default. Many discussions of student loan default imply that, when a borrower defaults, he is unlikely to later fully repay the debt.[23] But a surprising number of defaulters repaid their defaulted loans in full.[24] Of all defaulters, 31 percent exited via a full payoff within five years (see Figure 4). Note that this rate captures only borrowers who resolve their defaults through a full payoff and not defaulters who rehabilitate or consolidate their loans and fully pay them off afterward. (Borrowers who successfully complete a soft exit and then quickly reduce their balances to zero are uncommon in the data.)

Figure 3. Reason for First Default Exit



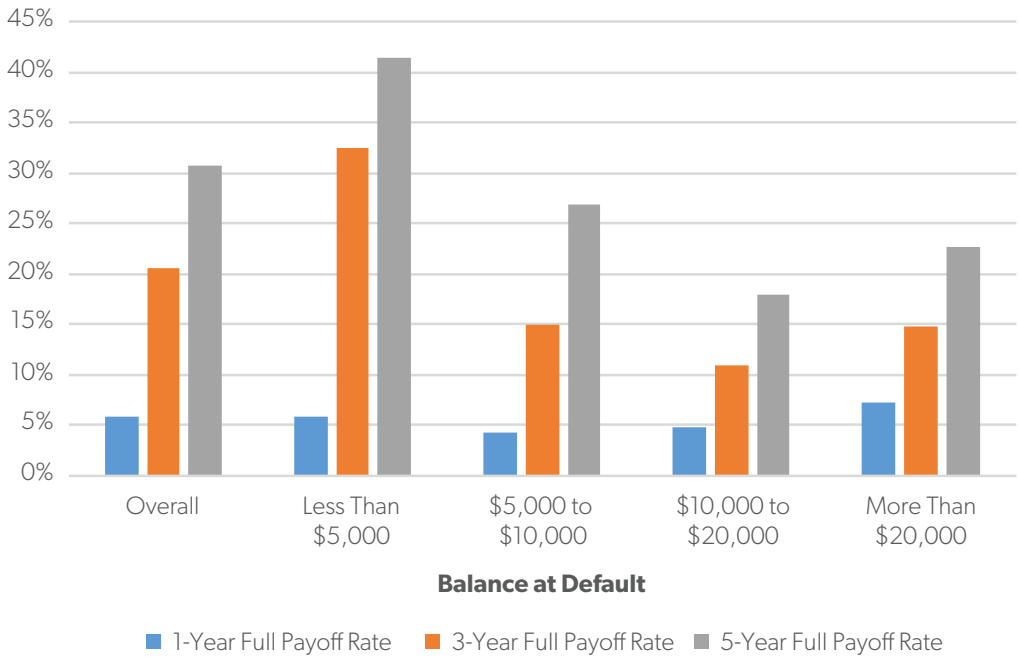
Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

One explanation for this finding is that many borrowers default on small balances, making it possible for borrowers to eventually pay them off. More than half of borrowers had less than $10,000 in outstanding debt when they defaulted, and nearly a third had less than $5,000. Indeed, defaulters with smaller balances paid down their loans much faster than those with larger balances. Among borrowers who had less than $5,000 in loans outstanding at the time of default, 41 percent exited default through a full payoff within five years. For borrowers with more than $20,000 outstanding at default, the full payoff rate was 23 percent.

The data do not include information on borrowers' incomes, so we cannot gauge how affordable these full payoffs are for defaulters. Moreover, the federal government has extraordinary tools such as wage garnishment to collect defaulted loans that can force borrowers of limited means to pay off defaulted loans quickly. Our model of wage garnishment outlined in the second section of this report shows that wage garnishment (combined with tax refund offsets) can lead even low-income borrowers to fully pay off small-balance defaulted loans within a couple years. While the BPS:04/09 data do not identify how payments are made, the large number of rapid payoffs we observe is consistent with use of wage garnishment and tax refund offsets as collection tools.

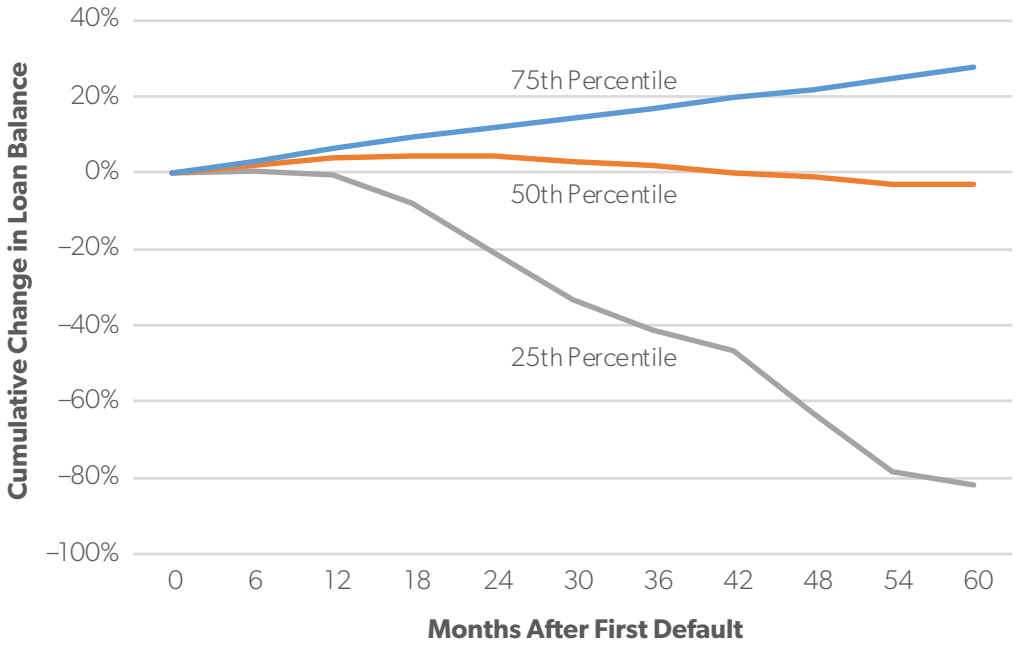
Loan Balances After Default. In the months and years after borrowers default, their loan balances evolve in divergent ways. Here we include the loan balances of all defaulters regardless of whether they take action to resolve the default. Some borrowers make substantial progress after default, while others make no progress or even see their balances increase.[25] Again, we cannot see borrowers' payments, so we cannot determine how much they are paying toward their loans relative to how much is due. But looking at balances alone, we see that defaulters at the median have paid down 3 percent of their balances five years after default (see Figure 5).

Figure 4. Full Payoff Rate by Balance Outstanding at Default



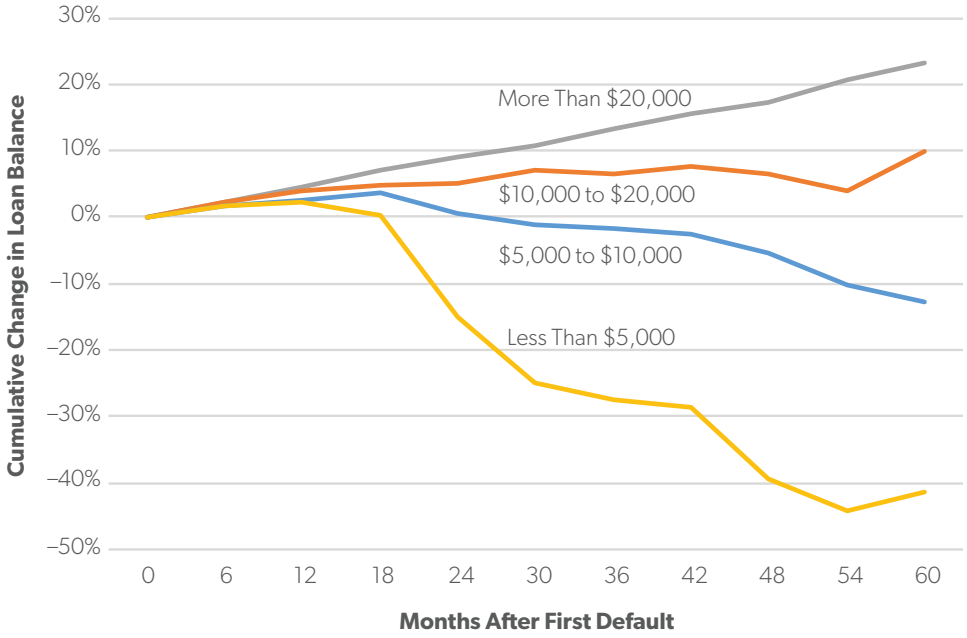
Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

Figure 5. Changes in Outstanding Loan Balance After Default



Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

Figure 6. Changes in Outstanding Loan Balance After Default, by Amount Owed at Default



Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

However, the median masks big changes for other borrowers. A minority of borrowers fully pay off their loans within five years, while balances rise sharply at the other end of the spectrum. Figure 5 shows that the 25th and 75th percentiles of borrower progress diverge further and further from the median as time goes by.

Five years after default, a quarter of borrowers have seen their balances grow by 28 percent or more. In other words, the 75th percentile borrower sees his balance grow by 28 percent. For comparison, a hypothetical borrower who makes no payments on a defaulted student loan for five years would see his balance grow by 34 percent, assuming the 6.8 percent interest rate charged on federal student loans during the mid-2000s.

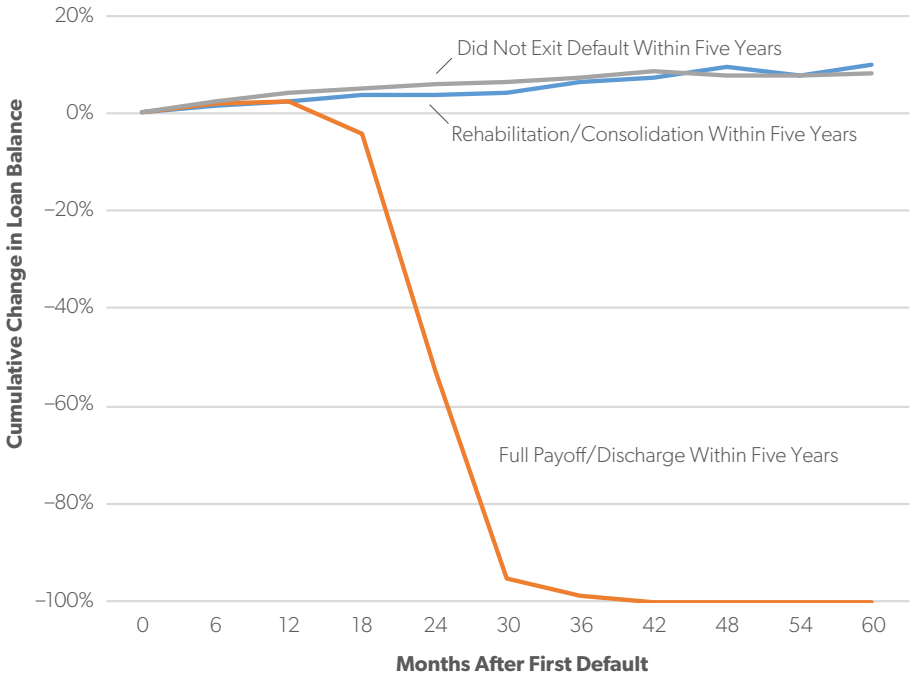
In addition to interest accumulation, outstanding balances may increase due to reborrowing. After exiting default, borrowers regain their right to borrow additional federal student loans, which contributes to higher balances in the years following default. We discuss reborrowing further in a later section.[26]

A sizable fraction of defaulters, however, make notable progress in paying down their loans. Within five years of defaulting, the 25th percentile borrower reduces his outstanding balance by over 80 percent. Put differently, a quarter of defaulters have less than 20 percent of their original balances remaining five years after defaulting.

Borrowers with lower balances at default tend to make faster progress paying down their balances (see Figure 6). The median borrower who enters default with less than $5,000 in debt pays down 41 percent of his balance within five years. But borrowers who owe more than $20,000 at default typically see their balances increase by 23 percent over the following five years. We cannot tell, however, if this latter group is making payments. If they are, it is not enough to keep up with accruing interest.[27]

People who pay down their balances quickly are obviously more likely to exit default through a full payoff. However, it appears the typical borrower who goes down the full-payoff route does not start making large payments immediately after default. Among

Figure 7. Changes in Outstanding Loan Balance After Default, by Reason for Default Exit



Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

borrowers who fully pay off or discharge their loans within five years, balances actually increase for the first year or so after default due to accrued, unpaid interest. Between 12 and 18 months after default, however, the balance of the typical borrower in this group takes a sharp turn downward. This suggests that borrowers who end up fully paying off their loans tend to spend a full year in default before they begin payments—either voluntarily or involuntarily. Accounting for the 270 days it takes to officially enter default, two years or more may pass between a defaulter's last payment and the time he begins to pay down his loans.

Borrowers who exit default through rehabilitation or consolidation generally do not, however, show progress paying down their balances (see Figure 7).[28] These soft default exits usually portend a borrower failing to make progress reducing his balance. Indeed, trends in the balances of borrowers who exit default through rehabilitation or consolidation are barely distinguishable from those who do nothing to exit default, at least in the five years we can observe. The typical borrower who rehabilitates or consolidates his defaulted loans sees his balance increase by 10 percent during this time.[29] Similarly, the typical borrower who did not exit default within that five-year period sees his balance increase at virtually the same rate.

There are many reasons that a borrower who rehabilitates or consolidates his loans would not make progress on the outstanding balance. He may simply fail to make payments after exiting default, raising the possibility of defaulting again. However, a soft-exiter may see his balance increase even if he does not redefault. Once a default is resolved, a borrower has legitimate channels through which to avoid making payments, such as placing loans into deferment or forbearance or enrolling in repayment plans that allow low-income borrowers to make zero payments.

Aside from interest, soft-exiters might see their balances increase for two other reasons. Borrowers freed of the default status may take out more federal student loans to go back to school, increasing their

Table 1. Four Pathways in Three Years After a Student Loan Default

	Balance Increases	Balance Decreases
No Exit	Group A (27%)	Group B (21%)
Exited	Group C (25%)	Group D (27%)

Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

total outstanding balance. Additionally, during the time period studied, relatively high collection fees were added to borrowers' rehabilitated and consolidated loans. These fees are far lower now.[30] Because of those fees, a borrower's balance might temporarily rise after a soft exit even if he is making payments. Regrettably, the BPS:04/09 data do not show when fees are charged.

Four Groups of Borrowers After Default. One useful way to categorize the findings is to divide defaulters into four categories based on whether they exit default within three years and whether they reduce their outstanding balances in the same period. This helps reveal the major theme of the findings thus far. Whether a borrower remains in default or exits says little about what happens to a borrower's loan balance after the default occurs. While one might expect borrowers who exit default to see their balances decline and vice versa, that is true about as often as it is not. The four categories defined in Table 1 are all of similar sizes, showing that repayment progress and default exit are almost completely orthogonal. To understand why, we explore each quadrant of Table 1 individually.[31]

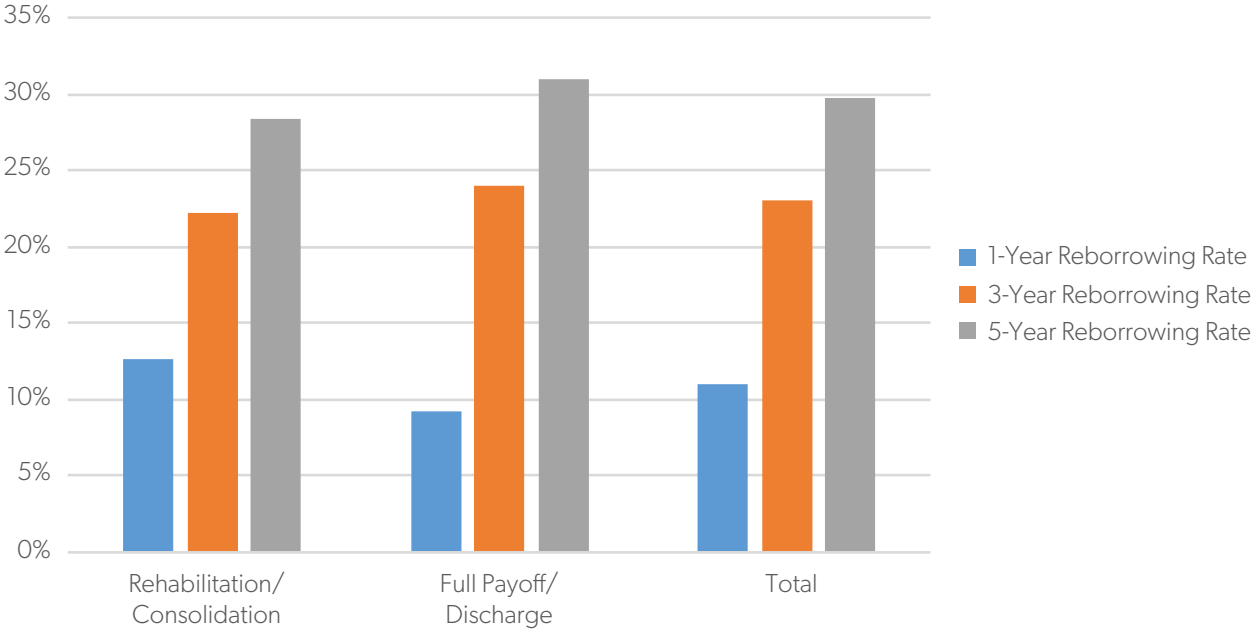
Group A: No Exit, Balance Increases (27 Percent). Group A is the 27 percent of defaulters who did not leave default and saw their outstanding balances rise. This is the stereotypical picture of a defaulter: a person who can neither quickly extricate herself from default nor pay down his outstanding balance. These borrowers are either not making payments at all or making voluntary or involuntary payments toward their loans that are not sufficient to cover interest. The median balance ($9,700) at default for these borrowers is somewhat high, which is expected given that it is more difficult to make progress paying down larger balances.

Group B: No Exit, Balance Decreases (21 Percent). Group B is the 21 percent of defaulters who did not exit default but reduced their outstanding balances. These individuals have not taken advantage of rehabilitation or consolidation but are making voluntary or involuntary payments that more than cover monthly interest and thus have started to pay down the principal. Many Group B borrowers are on track to fully pay off their loans within a few years (despite remaining in default) and thus will soon exit default. Unsurprisingly, these borrowers had somewhat lower, but not atypical, median balances at default ($7,000).

Group C: Exited, Balance Increases (25 Percent). Group C is the 25 percent of defaulters who left default within three years but failed to reduce their outstanding balance. Most of these borrowers rehabilitated or consolidated their defaulted loans but then saw their balances rise due to interest accumulation, fees, or reborrowing.[32] Some Group C borrowers are in danger of redefaulting if they fail to keep up with their new monthly payments after exit. Still others place their loans into deferment or forbearance, during which time they are not required to make payments but interest still accrues. These borrowers had the highest median balance at default ($10,800) of any category.

Group D: Exited, Balance Decreases (27 Percent). Group D is the 27 percent of defaulters who left default

Figure 8. Reborrowing Rate After First Default Exit



Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

within three years and reduced their outstanding balances. With the smallest median balance at default of any category ($4,000), most Group D borrowers exited default by fully paying off their defaulted loans (or having them discharged). However, slightly more than a third of this group rehabilitated or consolidated and are now making voluntary payments to fully pay off their remaining debt.

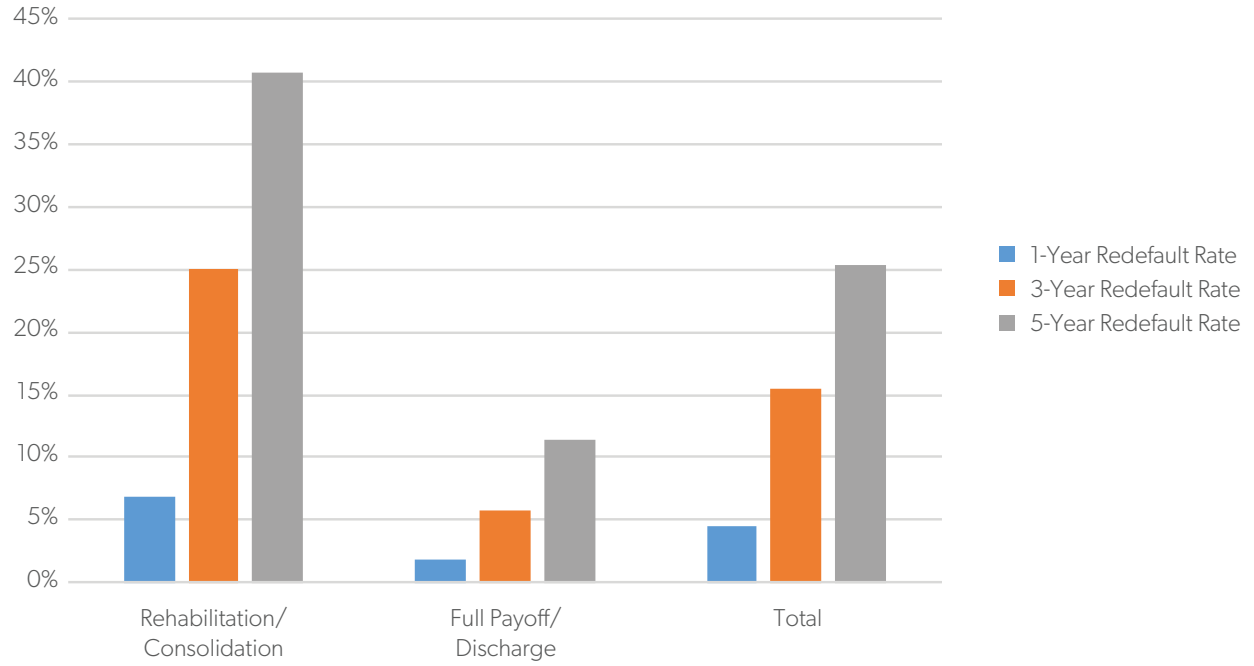
As time goes on, more and more borrowers will exit default at least once, either by fully paying off their defaulted loans or by using a soft exit to bring their debt back into good standing. However, the increasing exit rate does not mean that more defaulters will start paying down their outstanding balances. Five years after default, borrowers remain close to evenly divided between those paying down their loans and those not making progress.

Exiting Default and Taking Out Loans Again (Reborrowing). One reason borrowers may seek to exit default is so they can return to school by accessing more federal student loans (and federal grant aid). Borrowers in default are prohibited from taking out new student loans, but borrowers who defaulted in the past and exited default—through rehabilitation, consolidation, or full payoff—may take out new loans. As most student loan defaulters in our data (67 percent) did not complete their degree or certificate programs, it makes sense that they want to go back to school and finish.

After exiting default, this reborrowing is actually quite common (see Figure 8). One year after exiting default, 10 percent of borrowers have taken out a new federal loan (excluding consolidation loans). After five years, the reborrowing rate rises to 30 percent. In other words, default exiters often delay using their newfound ability to reborrow, possibly because going back to school is not among their most immediate concerns or because they have other arrangements to make before they can reenroll.

Reborrowing rates are similar for both soft and hard default exits. As most defaulters did not complete their degrees and therefore have low balances, many people who want to go back to school can retire

Figure 9. Redefault Rate After First Default Exit



Source: Authors' calculations based on National Center for Education Statistics, Beginning Postsecondary Students Longitudinal Study: 04/09.

their defaulted balances quickly through a full payoff. For defaulters with larger balances, rehabilitation and consolidation are frequently used to restore the ability to reborrow.

Exiting Default But Defaulting Again (Redefaulting). Exiting default is not a guarantee of staying out. Borrowers may rehabilitate or consolidate their loans but not mend the factors that led them to default in the first place; this creates ideal conditions for a redefault. Some observers have also argued that administrative complexities, processing delays, and poorly designed policies may hinder borrowers who use rehabilitation to exit default from staying current on the loan afterward.[33] Indeed, 41 percent of borrowers who rehabilitate or consolidate their loans default again within five years (see Figure 9). This suggests that rehabilitation and consolidation are not effective at resolving a borrower's risk of default for good.

Even borrowers who resolve their defaults through hard exits have a nonzero redefault rate. This may seem surprising: How can borrowers who no longer owe money on their defaulted loans default again?

There are two ways. First, these individuals may borrow again and default on the new loans, leading to a redefault even though their original loans are fully paid off. Second, hard-exiters may have outstanding loans on which they did not originally default, but that enter default after the first loans' defaults were resolved. For borrowers who exit default through all channels, the total five-year redefault rate is 25 percent.

Individual Borrower Perspective: Penalties, Interest, and Fees Under Current Policies

Examining aggregate data on the balances of borrowers who default, as done in the first section of this report, provides an incomplete picture of default. It cannot reveal what happens to loans at the individual level during and after default. This obscures the effects of key policies. For example, the data do not allow us to directly observe how policies such

as collection fees affect a borrower's total cost of default. Nevertheless, this information is crucial to policymakers and the public.

To gain insight into the individual-borrower level during default, we researched the relevant government policies, analyzed statistics published by government agencies in addition to the BPS:04/09, and conducted extensive interviews with collection agencies, government agencies, and other organizations with expertise on the topic. We compiled a comprehensive list of policies that affect borrowers during default, which are shown in Appendix B. Through our interviews we also gained an understanding of how frequently different policies come into play. Using this information, we built illustrative models for each exit scenario to show how much borrowers pay in collection costs and how much interest they accrue.

Specifically, we model eight scenarios grouped into the two categories from the first section of this analysis: *hard exit*, in which the borrower voluntarily or involuntarily pays down the loan balance after defaulting and eventually brings the balance to zero, and *soft exit*, in which the borrower completes an administrative process to bring the loan back into good standing, even though he has not fully paid off his loan at that time. We estimate that the government and collection agencies recover $3.1 billion annually from borrowers making progress toward a hard exit from default.[34] Another $8.2 billion a year in loans leave default through soft exits, but because these are soft exits, the dollar figure is not the amount actually collected; it reflects the amount of debt that is brought current through consolidation or rehabilitation but not actually repaid at that point.[35]

In the hard-exit category we model:

- A lump-sum payment,
- Wage garnishment,
- Annual federal income tax refund offsets,
- Wage garnishment combined with annual federal income tax refund offsets, and
- A settlement with the collection agency and ED that reduces the borrower's debt, which is then paid in full.

For the soft-exit category we model:

- Loan consolidation, in which the borrower makes three on-time payments to qualify for consolidation,
- A second type of loan consolidation, in which the borrower enrolls directly into IBR to qualify for consolidation, and
- Loan rehabilitation, in which a borrower must make nine affordable payments within 10 months to return the loan to good standing.

Table 2 and summarizes each scenario and illustrates how a borrower's exit from default can greatly affect the costs incurred. It shows the total net cost of default for a $7,000 loan under each exit scenario relative to what the borrower would pay if he had never defaulted and repaid the loan in equal installments over the same period. When calculating the cost of default, we do not consider all the interest that accrues over the life of the loan as a cost, since interest still accrues during on-time repayment. Instead, we count only the net interest a loan accrues because of the default.[36]

This net interest results from two dynamics. In one, the borrower accrues more interest in default because he is not making payments for many months whereas when he pays a loan on an amortizing, on-time schedule, he reduces principal with each payment, reducing his total interest accumulation. The other dynamic relates to collection fees being deducted from each payment in certain default exit scenarios, which slows principal reduction and increases interest accrual. In contrast, a borrower making on-time payments has all of his payments credited to principal and interest, which reduces his principal faster and ultimately reduces the interest that accrues during repayment relative to default.

The remainder of this section discusses the figures in Table 2. The table in Appendix C provides

Table 2. Net Cost of Default and Months to Payoff, by Exit Scenario ($7,000 Loan Balance)

Default Exit[1]	Total Net Cost	Net Interest	Collection Fees	Months (Years) to Full Payoff[2]
Lump Sum	$2,415	$470	$1,945	34 (2.8)
Wage Garnishment	$2,610	$500	$2,110	75 (6.3)
Tax Refund Offsets	$501	$399	$102	94 (7.8)
Garnishment Plus Offsets	$1,685	$418	$1,267	57 (4.8)
Settlement	$397	$397[3]	$0	36 (3)
Consolidation, Three Payments	$969	$678	$291[4]	180 (15)
Consolidation, Income-Based Repayment[5]	$845	$654	$191[6]	155 (12.9)
Rehabilitation	$781	$772	$9	185 (15.4)

Notes: 1. Wage Garnishment, Garnishment Plus Offsets, and Rehabilitation scenarios assume the borrower's annual income is $25,000.
2. Months to payoff is the time it takes a borrower to pay off his loan from the time he first stops making payments before entering default.
3. This is the amount of interest remaining after $42 of the interest owed is waived in the settlement.
4. At the point of consolidation, the 2.8 percent fee equals $219 and is added to the loan balance. As the borrower repays his loan, $72 in interest accumulates due to the fee, which is shown here as part of the fee.
5. Assumes borrower has a household size of two and an annual income of $35,000 such that the borrower pays off before receiving loan forgiveness.
6. At the point of consolidation, a $150 fee is added to the loan balance. As the borrower repays his loan, $41 in interest accumulates on the fee, which is shown here as part of the fee.
Source: Authors' calculations.

more detailed information about the net cost of each scenario.

None of the scenarios we model are rare or unusual based on our interviews. However, borrowers often experience more than one, such as having a tax refund offset and then opting to consolidate to exit default or having their wages garnished for a short period and then opting to rehabilitate their loan. Similarly, borrowers who use a soft exit may subsequently redefault or postpone payments for years in forbearance rather than remain on a steady payment plan after exiting default. We do not model a default exit scenario in which the borrower has government benefit payments (e.g., Social Security) offset because it is a far less common scenario.[37] We also do not include the effect a default has on a borrower's credit report, such as how much his credit score is reduced and for how long, except that we do note in each case if the default remains on the borrower's credit report after exiting default. A companion report to this one—"Underwater on Student Debt: Credit-Based Correlates and the Consequences of Student Loan Default" by Kristin Blagg of the Urban Institute—uses data from a credit reporting agency to examine how student loan defaults affect credit scores over time.[38] Blagg finds that, on average, a borrower's credit score declines by about 75–100 points upon entering delinquency and default but returns to its pre-default level within three to four years.

Assumptions for Modeling Default Exit Scenarios. To model the effects of each default exit scenario, we make a number of assumptions. For each scenario, we assume a $7,000 loan balance at the time the borrower made his last payment, which is approximately the median balance for borrowers who exit default.[39] We use the same initial loan balance for consistency and to help reveal the differences in the amount of fees, interest, and total payments that occur in each scenario. We use a 5 percent fixed interest rate, which is approximately the rate that borrowers pay on newly issued undergraduate loans in the federal program.[40] The models reflect only policies currently in effect for the Direct Loan Program.[41]

For simplicity and consistency, when the borrower exits default through a soft exit we assume he goes on to fully pay off his loan in fixed payments over a 12-year term.[42] In reality, many borrowers who exit default will redefault, use a forbearance to suspend payments, enroll in IBR, or reenroll in school and therefore qualify for a deferment. However, we assign a borrower a repayment schedule because we cannot otherwise assess the cost of default when the borrower uses a soft exit, as he has only changed the loan's status, not paid it off.

For simplicity, we do not discount dollar amounts to account for inflation or the time value of money. All figures are nominal. Note that some of the scenarios occur over long periods of time, meaning the nominal figures throughout the analysis are overstated because they are not discounted to a present value.

Our models incorporate a number of general policies that apply to federal student loans in default regardless of how the default is resolved. One is that ED does not charge borrowers late fees or higher, penalty interest rates during delinquency or default. For example, a borrower who misses five payments is assessed only interest at the original rate. While interest still accrues during delinquency or default, it is only added to the principal (i.e., capitalization or compounding interest) in certain circumstances.[43] That is, a borrower who has interest accumulate on a defaulted loan is typically not charged interest on the interest. The exception is when a borrower consolidates his loans to exit default, which is discussed more below.

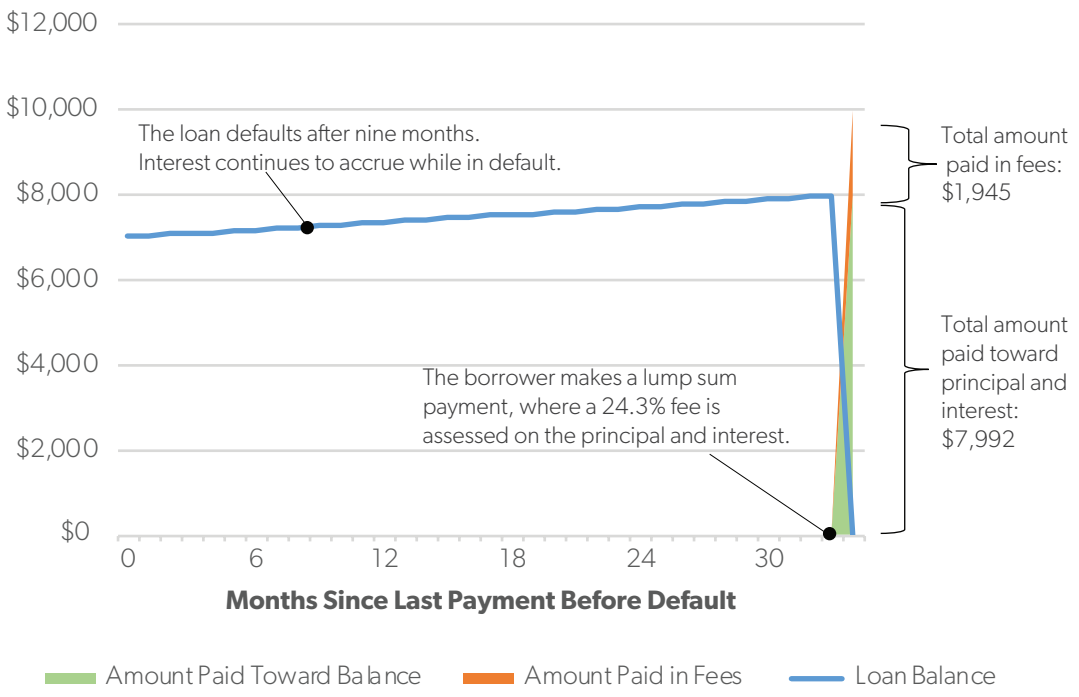
Another effect we incorporate into our models is that the process of defaulting spans many months, and even borrowers who ultimately exit remain in that status for many months. A technical default occurs when a borrower fails to make an on-time payment for 270 days.[44] But it takes about 150 additional days for the servicer to transfer the loan to ED and then for ED to issue a final letter to the borrower, notify credit reporting agencies, and assign the loan to a collection agency.[45] Even after that point, a full year often lapses before a default exit begins to occur.

Therefore, our models assume that the borrower remains in default for 24 months after technical default. We assume that he does not make payments on the loan during those 270 days nor during the additional 24 months. We also assume that he does not use a forbearance or deferment to postpone payments and that involuntary payments (such as wage garnishment and tax refund offsets) do not occur until the end of this period. Due to interest accrual during this time, the original $7,000 balance in each scenario increases to $7,992 before the borrower begins to exit default.[46]

Next we turn to the illustrative examples for each of the eight default exit scenarios. These illustrations describe the government policies that affect borrowers in default in each scenario, and they form the basis for the figures in Table 2.

Lump-Sum Payment. One of the most straightforward ways a borrower can exit default is by fully paying off the loan with a one-time, lump-sum payment. The data analysis in the previous section and our interviews suggest that some borrowers do indeed take this path to exit default, especially if the outstanding balance is small. Until recently, borrowers could pay off defaulted student loans with a credit card, meaning borrowers may not have actually paid off the debt.[47] While borrowers can negotiate a reduced balance in a settlement with the collection agency, here we assume no settlement. This scenario might occur if the borrower does not know that he can ask for a settlement if he pays off all at once or if the collection agency does not alert the borrower to this option. (We cover settlement as a separate scenario.)

Figure 10. Defaulted Loan Repaid with a Lump-Sum Payment



Note: The analysis assumes a $7,000 loan balance, 5 percent annual interest rate, and a voluntary, lump-sum payoff after the borrower remains in default for 24 months.
Source: Authors' calculations.

Figure 10 illustrates how a borrower's loan grows while in default, the collection costs charged, and the total payments made when exiting default with a lump-sum payment. Under current policy, a borrower in this scenario would be required to pay an additional 24.3 percent of his outstanding principal and interest balance ($1,945 in this case) as a collection fee at the point he makes the payment.[48]

Congress gives ED discretion in statute to determine reasonable collection costs.[49] That is, the government sets the collection fees, not the collection agency. The fees are remitted to ED and do not compensate collection agencies directly for their services. Instead, ED compensates collection agencies under contract terms that are not the same as what those entities must charge borrowers. This report does not focus on those contract terms or payments to collection agencies.[50]

Adding in the collection fees means the borrower's total payment required to satisfy the debt is $9,937. However, some of that amount is interest the borrower would incur even if he had not defaulted. Therefore, we compare the total amount owed with a loan in good standing that is paid off in equal installments over the same period. This reveals that the net cost of default is $2,415, which is almost entirely due to collection fees[51] (see Table 2). Once his loan is fully paid off, the borrower's credit report would typically reflect that his defaulted loans were paid off, but the default may remain on a borrower's credit report for seven years.[52] A default that is later paid off generally has less effect on a borrower's credit report than an outstanding unpaid loan.[53]

A variation on the lump-sum payment scenario is when a borrower makes periodic payments while in default that fully pay off the loan over time, including interest and collection fees. It differs from the lump-sum scenario only in that the borrower incurs slightly more interest from the longer time period in

default—and the additional collection fees assessed on the larger balance as a result of the additional interest.[54] Another important difference about making periodic payments is in the way collection fees are assessed. Under ED policy, a fee is deducted from *each payment* with the remaining portion of the payment credited to accrued interest and then principal. The collection fees are the same as in the lump-sum scenario, but when expressed as a share of each payment rather than the entire balance, they total 19.6 percent.[55] Making periodic payments to exit default looks similar to exiting default through another scenario—wage garnishment—which we illustrate next.

Lump-sum and periodic payments are voluntary, unlike payments made through wage garnishment or tax refund offsets. We estimate that about 12 percent of all dollars collected annually from borrowers making progress toward a hard exit from default come from voluntary payments, including voluntary payments under a settlement discussed later.[56]

Wage Garnishment. Another way that borrowers can exit default is by having their wages garnished. The government collects about twice as much annually through this method than through the voluntary payments discussed above. Under wage garnishment, the collection agency assigned to the borrower's loan instructs the borrower's employer to deduct 15 percent of his disposable pay from each paycheck and remit it to the government. However, the employer must leave the borrower with at least $218 per week.[57] Disposable pay is defined as any income after the borrower pays expenses required by law, such as state, local, and federal taxes.[58]

Initiating wage garnishment can be a lengthy process for collection agencies, which are charged with carrying out this collection method. Before garnishment can begin, the collection agency must first locate the borrower's place of employment. The agency must also make a number of attempts to contact the borrower by phone and mail over a specific period of time before initiating garnishment. If the collection agency successfully locates the borrower's place of employment and has made the requisite attempts to contact the borrower, the agency can initiate the garnishment order with his employer. Even at this point the borrower still has 30 days to respond before his employer is notified to withhold loan payments from his wages. Borrowers can also request a hearing with ED to dispute the garnishment for a number of reasons, and borrowers who have been involuntarily separated from their employment cannot be subject to garnishment until they have been continuously employed for at least 12 months.[59] In a qualitative study, borrowers reported having their wages garnished years after their loans became delinquent.[60]

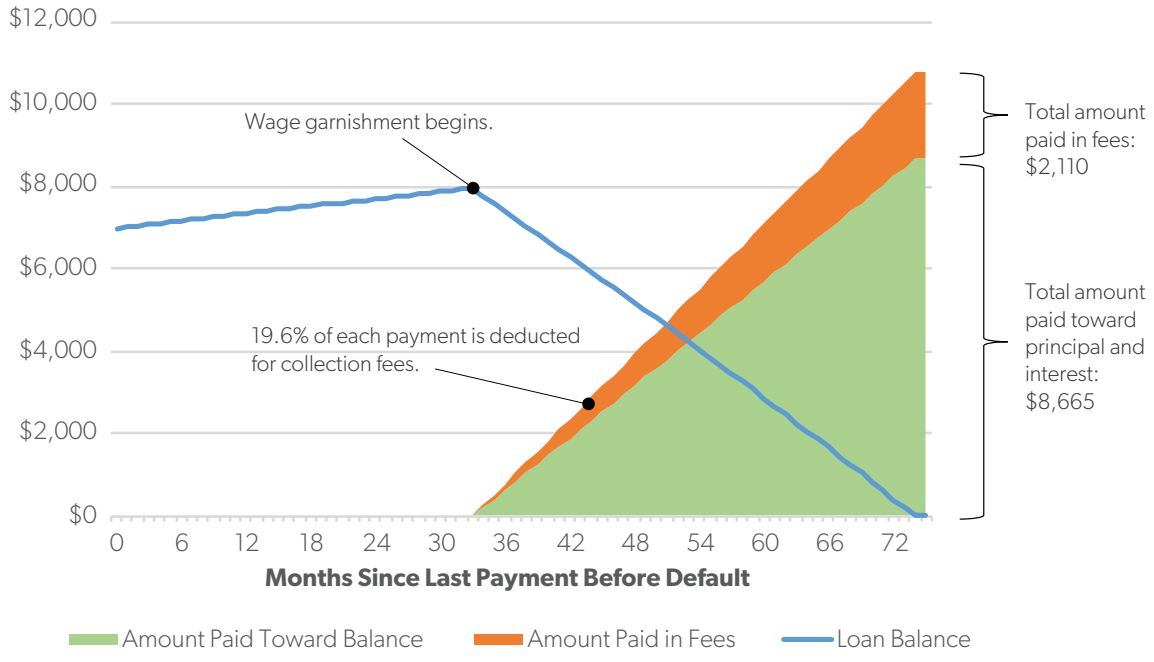
Borrowers in wage garnishment must also pay collection fees to ED. As is the case when a borrower makes periodic payments while in default, 19.6 percent of each payment is deducted for collection fees.[61] The remaining portion of each payment is credited to interest and then principal.

Turning to our model of exiting default through wage garnishment, we assume that the borrower has an annual income of $25,000, which means his monthly loan payments under the garnishment are $263.[62] (We were not able to obtain information about typical incomes of borrowers in wage garnishment.) Only $211 of each payment is applied to his balance because 19.6 percent of each payment is deducted for collection costs. This slows the rate at which he pays down the debt and increases his total interest costs.

We assume the borrower continues to pay down his balance through wage garnishment until it is completely paid off, which takes 42 months from the start of the garnishment, as shown in Figure 11. Once the loan is fully paid, the borrower's credit report typically reflects that his defaulted loans were paid but the default remains on the report for seven years.[63] A hard exit from default through wage garnishment results in this borrower paying $10,775 in total, compared with $8,165 for a loan that remains in good standing, meaning the default costs him $2,610, largely from collection fees[64] (for a full breakdown of the costs, see Table 2).

Tax Refund Offset. In addition to wage garnishment, borrowers can involuntarily exit default and fully pay off their loans when their income tax refunds are offset by the government and used to pay defaulted

Figure 11. Defaulted Loan Repaid Through Wage Garnishment



Note: The analysis assumes a $7,000 loan balance, 5 percent annual interest rate, $25,000 income, and monthly wage garnishment of $263 beginning after the borrower remains in default for 24 months. No other payments occur.
Source: Authors' calculations.

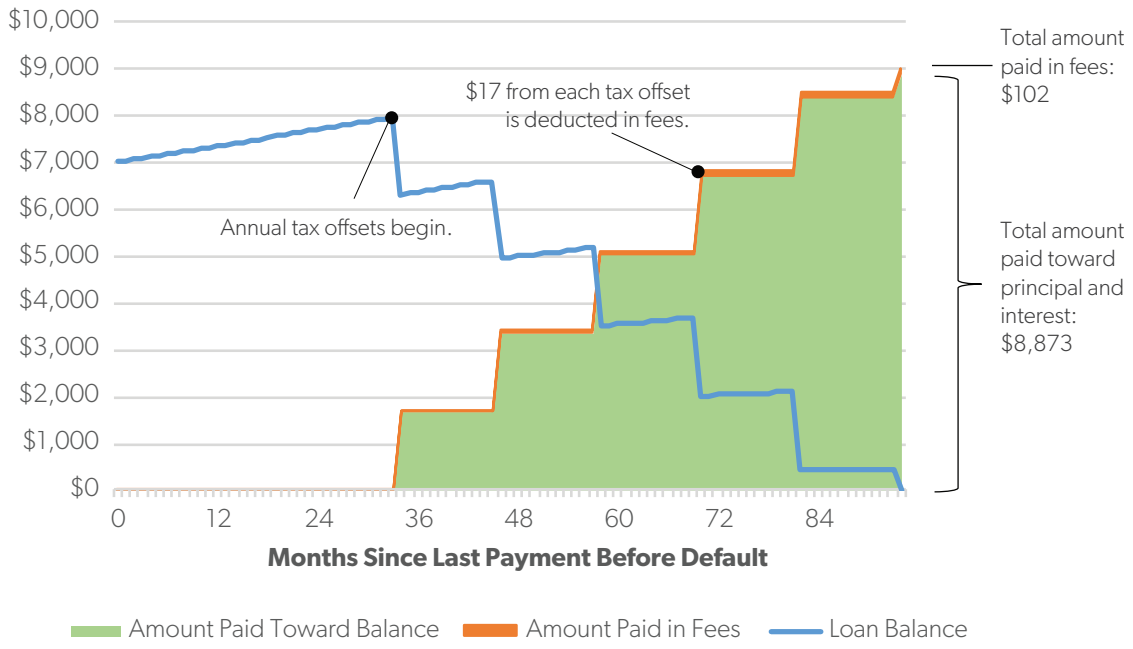
student loans. Tax filers are owed a refund when they overwithhold federal income taxes each year, but they can also qualify for a refund even if they do not owe income taxes through a "refundable" tax credit such as the earned income tax credit. This collection effort is run by the Department of Treasury, not collection agencies or ED, although ED must certify and submit loans to the Treasury for offset.[65]

Like wage garnishment, tax refund offsets do not occur immediately upon default. First, ED must certify that a borrower has a defaulted loan, notify the borrower that his refund will be offset, and provide him time to request a hearing to dispute the action or make a hardship claim. This can take up to 15 months after a borrower has defaulted because ED only periodically certifies loans for offset.[66] Another source of delay is that the Treasury issues tax refunds only once a year, in line with the annual tax filing season.

Tax refund offsets for federal student loans total $2.1 billion annually. Tax refund offsets bring in nearly twice as much money annually as wage garnishment and voluntary payments combined and are therefore a major source of payments toward defaulted loans.[67] The typical refund offset to pay student loans is $1,700.[68] The Treasury deducts a flat $17 fee per offset from the payment toward the student loan, which covers the administrative costs incurred by Treasury. A $17 fee is just 1 percent of a $1,700 refund, meaning that a borrower who pays only through tax refund offsets (albeit, involuntarily) pays low collection costs relative to making voluntary payments or involuntary payments through wage garnishment.

A borrower who has $1,700 offset once per year will make relatively slow progress paying down a federal student loan in default. As shown in Figure 12, it would take about eight years to fully repay the $7,000 loan with tax refund offsets alone, since payments would be applied only once per year and interest accrues during this time. Such a borrower pays just $102 in collection costs.[69]

Figure 12. Defaulted Loan Repaid Through Tax Refund Offsets



Note: The analysis assumes a $7,000 loan balance, 5 percent annual interest rate, and an annual tax refund offset of $1,700 beginning after the borrower remains in default for 24 months. No other payments occur.
Source: Authors' calculations.

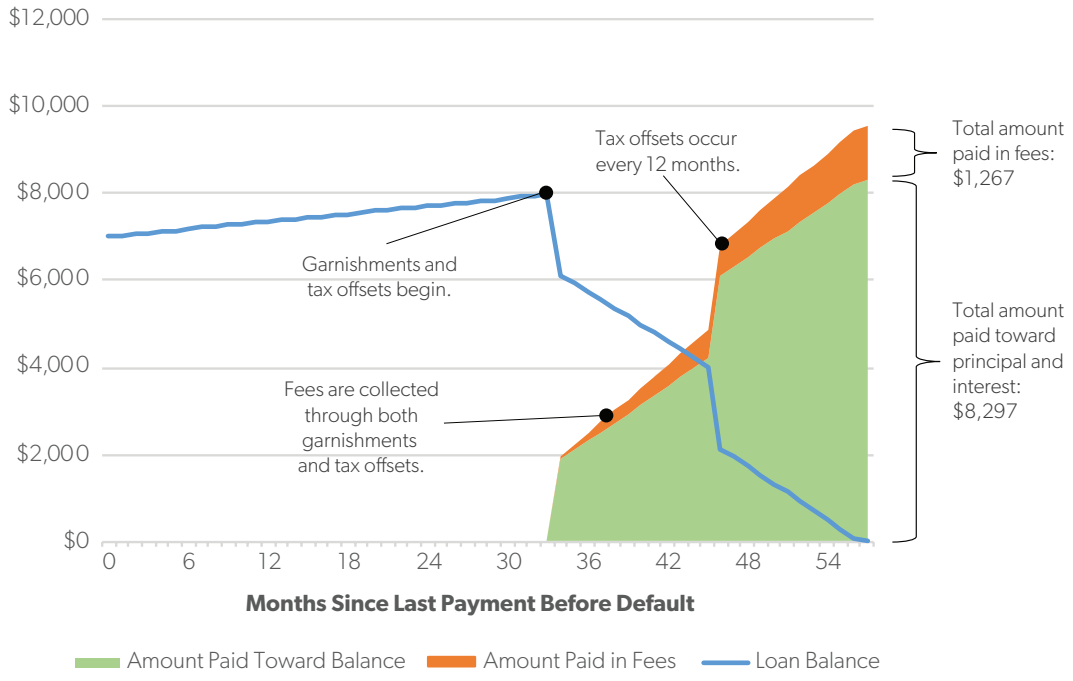
Tax Refund Offsets and Wage Garnishment. Borrowers in default can also be subject to tax refund offset and wage garnishment simultaneously. We model such a scenario in Figure 13. Comparing the payments in default with a loan repaid in good standing over the same period reveals that the net cost of default in this scenario is $1,685, which is largely collection costs (see Table 2). Note that costs are lower in this scenario than if the borrower only had wages garnished because the $17 (1 percent) fees charged against his tax refund offsets are much lower than those charged under wage garnishment (24.3 percent).

Settlement. The final type of hard exit from default that we model is a settlement. Under ED policies, borrowers can obtain a settlement by working with the collection agency. There is no publicly available description of this policy, but interviewees said a typical settlement allows the borrower to pay 80 percent of the combined total of outstanding principal, interest, and the 24.3 percent in collection fees to satisfy the debt. The borrower must, however, pay the settlement amount within 90 days. Following the full payment, the borrower's credit report typically reflects that his defaulted loans were repaid, but the default remains on the report for seven years.[70] Interviewees said that settlements are a routine exit for defaulters, especially those with low balances, although the available data do not indicate how many borrowers receive settlements.

Figure 14 illustrates a defaulted loan repaid under this arrangement in which the borrower's $7,992 balance is eventually paid off under a settlement for $7,949.[71] In other words, the 80 percent calculation results in this borrower having all collection fees waived and even a small amount of interest. However, he must pay the full settlement amount in just 90 days after agreeing to these relatively favorable terms.

A settlement is not the only option borrowers have to minimize collection fees: All the soft-exit

Figure 13. Defaulted Loan Repaid Through Wage Garnishment and Tax Refund Offsets



Note: The analysis assumes a $7,000 loan balance, 5 percent annual interest rate, $25,000 income, monthly wage garnishment of $263, and annual $1,700 tax refund offset. It also assumes wage garnishment and offsets begin after the borrower remains in default for 24 months and no other payments.
Source: Authors' calculations.

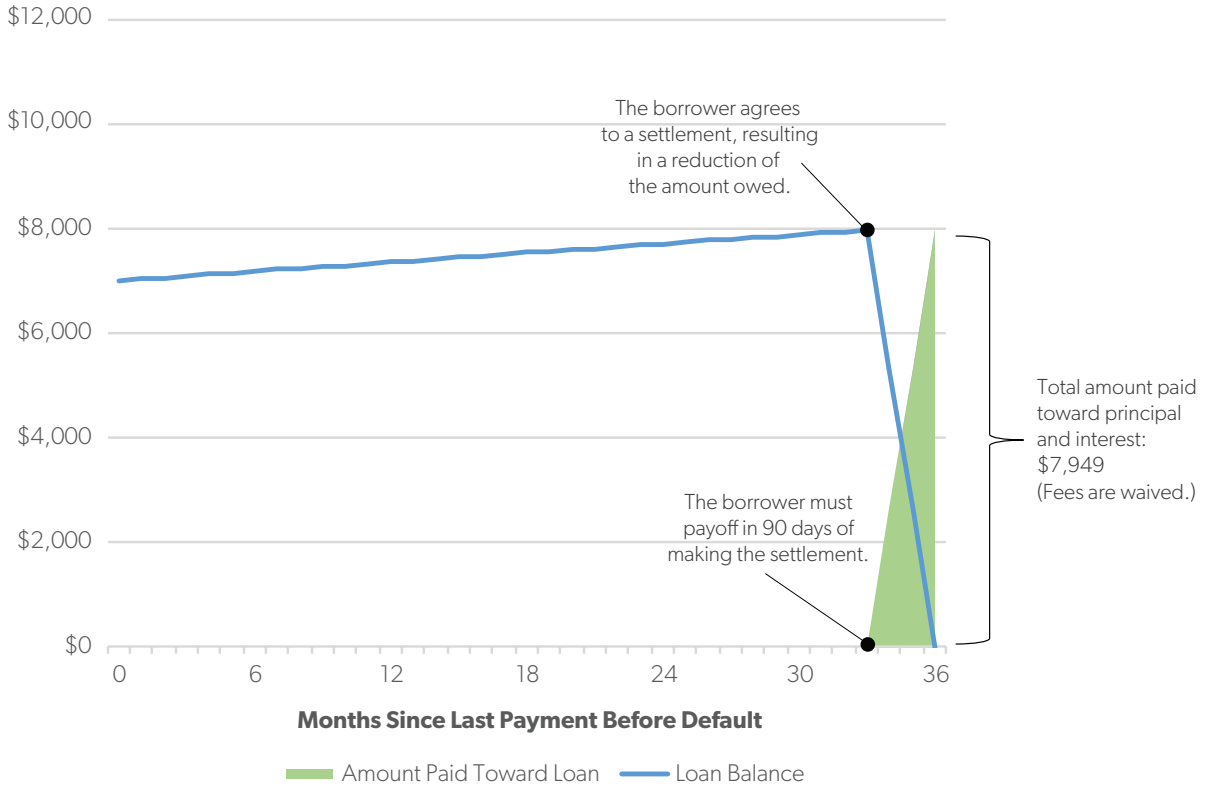
scenarios involve reduced collection fees, and we turn to those next.

Consolidation. Loan consolidation is another way to exit default and minimize collection costs. This is a soft exit because the loan merely changes status; it is not paid down. Consolidation is listed in statute as a method for exiting default, meaning Congress explicitly created this soft-exit option for borrowers.[72] Under consolidation, the borrower is issued a new federal student loan that pays off all his loans in default. The new consolidation loan is automatically in good standing because it is a new loan and is therefore eligible for all repayment plans and benefits. The borrower is also eligible to take out additional federal student loans and receive any grant aid for which he is eligible.

Consolidation is the fastest way to exit default without fully paying down the loan. Moreover, the borrower's credit report typically reflects that his defaulted loans were paid off but the record of default remains on his credit report for seven years.[73] This is the same status a borrower would receive if he fully paid off his federal loans through a hard exit from default even though he has not actually paid off his loans. According to ED statistics, about $1.4 billion in defaulted loans exit annually through consolidation, or about 16 percent of all hard and soft default exits combined.[74]

Another benefit of consolidation is that the repayment term is longer than the original loan, between 12 and 30 years, with larger balances qualifying for the longest terms. Despite the name, borrowers can use this option even if they have only one federal student loan, and it is a popular repayment plan outside of default. Many borrowers use the consolidation option when current on their loans to access longer repayment terms or simplify repayment on multiple loans. That poses a problem for some borrowers in default. Under

Figure 14. Defaulted Loan Repaid Through a Settlement



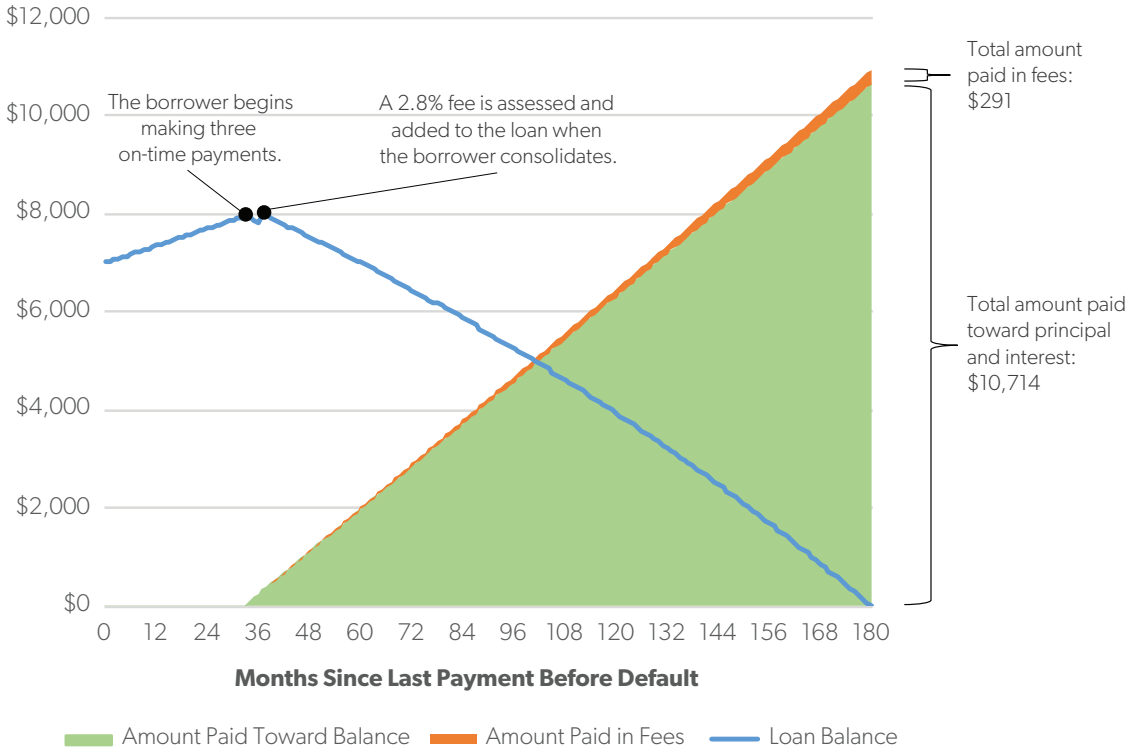
Note: The analysis assumes a $7,000 loan balance and 5 percent annual interest rate. It also assumes the borrower remains in default for 24 months before entering a settlement, in which 20 percent of the combined principal, interest, and fees are waived, and the loan is fully repaid in 90 days. No other payments occur.
Source: Authors' calculations.

the law, borrowers can consolidate only once (unless they subsequently take out more loans).[75] Thus, a borrower who consolidates *before* defaulting cannot use this option to exit default as he has already consolidated his loans. Another restriction is that the statute prohibits a borrower whose wages are garnished from receiving a consolidation loan.[76] Therefore, the borrower must work with the collection agency to have the wage garnishment order suspended before he can receive the consolidation loan and exit default.

There are two versions of consolidation to exit default, and both require the borrower to complete paperwork. ED does not break out its statistics on defaulted loan consolidations by type of consolidation. Under the first type, the borrower must make three on-time payments in which each payment is equal to 1 percent of the outstanding principal and interest balance of his defaulted loans.[77] Once he satisfies the requirement, he is issued the new consolidation loan and enters repayment in good standing. According to ED policy, he is assessed a fee equal to 2.8 percent of the combined principal and interest on his loans in default, which is then added to the principal balance of the new loan, along with all interest that accrued during default.[78]

This is the only case in which accrued interest is added to the principal balance on this loan (i.e., capitalized) during default. Some organizations we interviewed believed this aspect of consolidating loans to exit default was punitive and costly to the borrower, but our analysis suggests it is not a major factor in the overall cost of defaulting. Compounded interest from

Figure 15. Defaulted Loan Repaid Through Consolidation (Three-Payment Option)



Note: The analysis assumes a $7,000 loan balance and 5 percent annual interest rate. It also assumes the borrower remains in default for 24 months and then obtains a 12-year consolidation loan after making three payments. Interest and the 2.8 percent collection fee are added to the balance of the new loan, and the new loan is fully repaid over 12 years. The collection fee grows over time because the borrower pays interest on the fee.
Source: Authors' calculations.

a consolidation in our $7,000 loan example adds less than $100 to the total cost of default over a 12-year repayment term.

After the borrower makes the three on-time payments, he must immediately begin making monthly payments on the consolidation loan issued to exit default, provided he does not enter a deferment or forbearance or have his payments set to $0 by subsequently enrolling in IBR. Borrowers who reenroll in school at least half time will automatically have their new consolidation loan put in deferment.

Some interviewees thought few borrowers used the three-payment consolidation option or that administrative hurdles made it impossible to use. However, collection agencies we interviewed reported that it is not an uncommon resolution process.

Figure 15 illustrates this option for exiting default. In this scenario, the borrower makes three $80 monthly payments (1 percent of the balance in default) on his $7,992 balance. Following those payments, he is issued a consolidation loan which includes a 2.8 percent collection fee ($219 in this case), making his new balance $8,029. The new repayment term is 12 years based on the rules for consolidation loans under $10,000.[79]

Under this soft exit from default, the borrower pays a total of $10,933, which reflects his 12-year repayment term after exiting default and the three upfront payments required for consolidation. This is more than the total payments in the other scenarios because the consolidation loan stretches the payments out over a longer period and more interest

accrues. If he had never entered default and regularly paid off under the same amount of time in the model, he would have paid a total of $9,964, meaning the net cost of default is $969. Most of that amount is the additional interest accrued from deferring payments while in default.

A borrower can skip the three-payment requirement to exit default through consolidation if he enrolls in IBR. Under this option, the borrower completes combined paperwork for IBR enrollment and a consolidation loan. When the borrower is issued the new loan, his payments follow those under the IBR program, which is 10 percent of income after an exemption equal to 150 percent of the federal poverty guidelines. The borrower incurs a flat collection fee of $150 in this option rather than 2.8 percent of the balance in the three-payment consolidation option.[80] This fee and the interest that accrued while in default are added to the new loan balance (i.e., capitalization). Table 2 shows that this option costs borrowers slightly less than exiting through the other consolidation option mainly because the fee is marginally lower.[81]

Rehabilitation. The final option for a soft exit from default is rehabilitation. Like a settlement or consolidation, this benefit also results in the borrower having most of his collection costs waived but offers a unique additional benefit. Once a borrower completes a rehabilitation, the government will request that the credit reporting agency remove the default from his credit report.[82] Although the delinquency (i.e., late payments) that led up to the default will remain on his report, the organizations we interviewed noted that a default has more severe effects on a borrower's credit report than a delinquency. Borrowers can only rehabilitate a loan once, meaning the option is not available for the many borrowers who redefault.[83] Rehabilitation is the most common soft exit from default and the most common exit pathway overall, with just over 70 percent of dollars in both exit categories, or about $7 billion annually.[84]

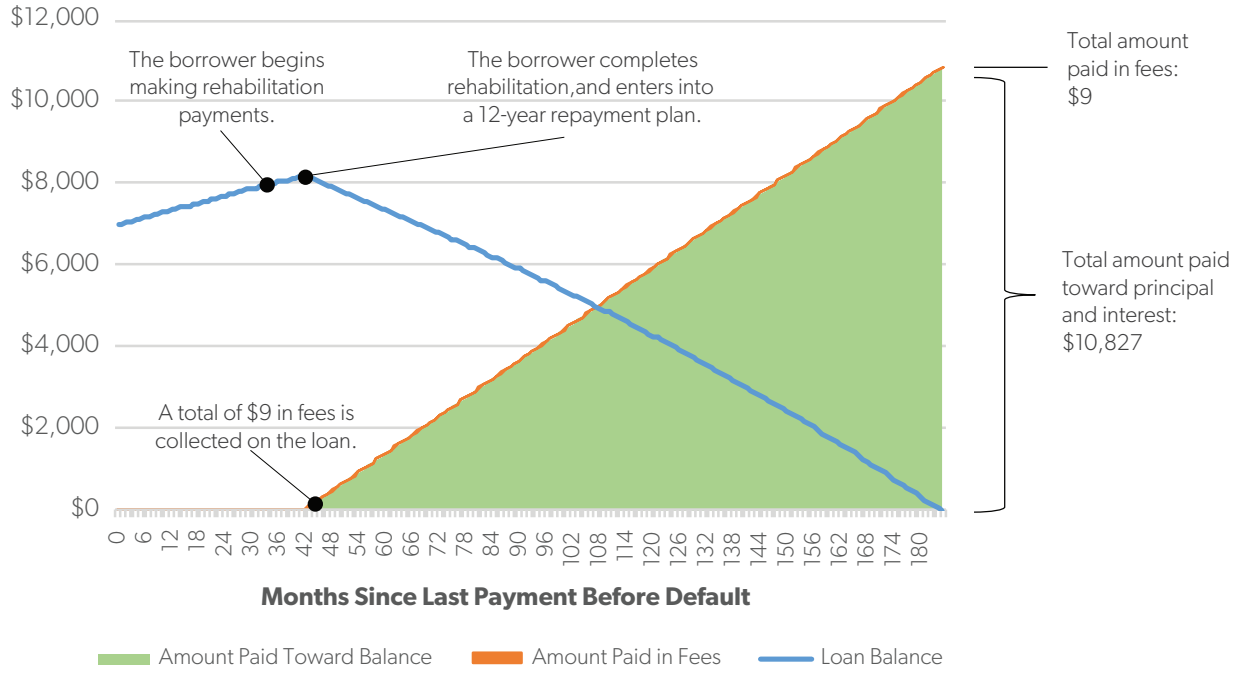
A rehabilitation, like consolidation, is defined in statute as a means to exit default.[85] The law specifies that the borrower make nine on-time voluntary payments to have his loan rehabilitated. Under current regulations, these payments are 15 percent of a borrower's income after an exemption of 150 percent of the federal poverty guidelines.[86] If this calculation results in unaffordable payments, a borrower can submit a standard ED form to the collection agency documenting his expenses to obtain a lower payment.[87] Under either calculation, payments must be at least $5.[88] Once a borrower completes the nine payments, his loan(s) are returned to good standing, and he becomes eligible for the terms and repayment plans available on federal student loans, such as IBR, a forbearance, or an in-school deferment. However, payments may be higher than those the borrower obtained by completing the expense form.

The borrower is assessed a collection fee in the form of a 19.6 percent deduction from each of the nine payments he makes while rehabilitating his loan.[89] But once he successfully completes those payments and rehabilitates the loan, there are no further collection costs.[90] Thus, his collection costs could be as low as $9 if his monthly payments are set at the $5 minimum. Interest that accrued while in default is not added to the principal balance (i.e., capitalized) when his loan returns to good standing. He still owes the unpaid interest, however, and the payments made after the loan is returned to good standing are credited to this interest first.

Borrowers whose wages are garnished can use rehabilitation to exit default, but their payments under garnishment continue and do not count toward the nine on-time payments, since the rehabilitation payments must be voluntary.[91] However, after the borrower makes five of the nine payments under the rehabilitation plan, he can have the garnishment order suspended.[92]

Figure 16 illustrates the effect of defaulting and exiting through rehabilitation. We assume the borrower's income is low enough that he needs to make only $5 minimum payments in rehabilitation. (However, various sources we consulted suggested that typical monthly payments in rehabilitation range from $35 to $75 per month.) After making those payments and after 98 cents (19.6 percent of $5) in collection fees are netted out of each payment, the borrower

Figure 16. Defaulted Loan Repaid Through Rehabilitation



Note: The analysis assumes a $7,000 loan balance and a 5 percent annual interest rate, and income of $25,000. It also assumes the borrower remains in default for 24 months and then rehabilitates after making nine payments. The loan is then fully repaid over a 12-year term.
Source: Authors' calculations.

returns his loans to good standing, owing $8,189. Assuming a 12-year fixed payment term thereafter brings his total payments to $10,836. If the borrower had never defaulted and repaid the loan over the same amount of time, he would have paid a total of $10,055, meaning the net cost of default was $781, which is almost entirely the additional interest accrued while delaying payments in default. And because the borrower used rehabilitation to exit default, record of the default is removed from his credit report.

Conclusion and Recommendations

For several decades, federal student loans have operated as an open-access program, without underwriting or collateral. As the program makes loans to almost any student attending an eligible institution, without a credit check in most circumstances, it should be unsurprising that default rates are as high as they are. While reducing defaults through IBR and other innovations is certainly possible, it is wishful thinking to assume that these policies will eliminate default. Policymakers who wish to maintain the open-access nature of the program must accept that a certain level of defaults is inevitable. Indeed, ED has not lowered its projection of lifetime default rates *at all* since the advent of IBR, even as enrollment in that plan has swelled in recent years.[93]

While policymakers should continue to address default prevention, some of their attention should shift to how borrowers can exit default. The current maze of inconsistent fees, penalties, and paperwork that borrowers must navigate to exit default is ripe for change. However, despite the complexity of exit policies, seven in 10 defaulters find their way out of default within five years. These encouraging statistics show that many borrowers have the means to

exit default and that policies to make those pathways smoother could leave both borrowers and taxpayers better off.

Policymakers could reform the default exit policies to make the system more rational, consistent, and fairer to borrowers. We generally take the view that, while some penalties for default are appropriate in order to compensate taxpayers for collection costs that ED incurs and to disincentivize default, the current set of options and penalties is inconsistent, opaque, counterintuitive, and either excessively punitive or extremely lax. To that end, we propose streamlining and rationalizing the existing system under the following framework. These reforms require changes to the underlying laws and ED's current policies.

Combine Rehabilitation and Consolidation into a Single "Resolution" Option. Currently, borrowers have three soft-exit options from default, each with unique requirements and fees. To simplify the exit process, policymakers should combine these alternatives into a single, quick option called a "resolution." To obtain a resolution, borrowers would simply elect this option as part of enrolling (or reenrolling) in any repayment plan available for borrowers in good standing, which can include reenrolling in the standard 10-year plan that all borrowers use automatically when first entering repayment. Borrowers would not need to have wage garnishment suspended to obtain a resolution, and garnishment would cease immediately following a resolution. While borrowers should be able to enter a resolution as many times as they want, second and third resolutions should carry stricter terms, possibly including a required minimum number of on-time payments, in order to disincentivize "serial resolutions." Our proposed redesign of collection fees, as discussed below, would also discourage serial resolutions.

Simplify Collection Fees. Under the current system, a borrower with a $7,000 loan can have all of his collection costs waived under a settlement or pay as little as $9 in penalties if he chooses a rehabilitation, pay $102 if he has his loan involuntarily repaid through tax refund offsets, or pay over $2,000 if he clears his balance with periodic voluntary payments. Strangely, only one of these options—the low-fee option that does not require he pay off the loan—clears his credit report of the default. Depending on the exit pathway chosen, penalties can therefore be overly harsh or far too lenient, given that it costs taxpayers more than $0 or $9 to recover a loan.[94] The current policy of deducting 19.6 percent from each payment for collection fees under some exit options is also excessively punitive because it increases how much interest a borrower accrues, creating a drag on the repayment progress—likely in a way that is not obvious to the borrower.

We suggest eliminating the current mix of penalties and fees and replacing it with a single charge equivalent to a flat percentage of a borrower's balance and applied to the loan at the time of default. This would apply to all defaulted loans regardless of how the borrower exits, and ED would no longer offer settlements. The fee would be applied again if the borrower redefaults after using the new resolution process to exit default.

While calculating an ideal fee that covers the government's costs is outside the scope of this report, for discussion purposes a 5 percent flat fee could be appropriate. This would mean that the $7,000 loan and default scenario we use throughout the second section of this report would incur a fee of $362.[95] In contrast to current policy, this fee would be universal; the government would assess it at the time of default on all defaulters no matter how they resolve the default. The borrower would then pay this 5 percent fee in the same way that he pays the rest of his loan—whether through voluntary payments, wage garnishment, or other methods—because it would be immediately added to his principal balance. We estimate that charging fees in this manner reduces costs for borrowers compared with deducting fees from each payment. Relative to the current default exit policies, this approach looks most similar to the consolidation option in which a percentage-based fee is added to the loan balance and repaid over time.

Charge Borrowers Additional Fees for Wage Garnishment. Involuntary payments through wage garnishment impose administrative costs on taxpayers and employers. It is reasonable for the government to expect that borrowers whose loans are collected through these channels pay some or all of their collection costs and that they face higher penalties for imposing costs on employers. We suggest that the government levy a flat fee for each payment made through wage garnishment or offsets to compensate taxpayers for collection costs. This fee should be set to cover the additional administrative costs of collecting loans through wage garnishment just as the same fees are currently calculated for the Treasury's tax refund offsets. We expect that these fees, while not insignificant, would be less than the current 20 percent per-payment fees assessed under wage garnishment. Still, all borrowers are assessed a flat 5 percent fee at the time of default under our proposal, which would include borrowers in wage garnishment. That is, the flat per-payment fee for wage garnishment is in addition to the 5 percent fee levied at the time of default.

The government should also maintain the current fees charged on tax refund offsets, as they are set to cover additional administrative costs. Borrowers for whom tax refund offsets or wage garnishment are unaffordable will be able to more easily suspend them than under current policy by using the new resolution process to quickly exit default and enroll in a new repayment plan, including IBR.

Delay Access to Loan Program Benefits After Resolution. This analysis has revealed that many borrowers who exit default take out federal student loans again. While resolution should be a single, simple process, borrowers who enter resolution should not immediately regain access to the full suite of benefits under the federal student aid programs—although they would be able to access any repayment plan as part of the resolution. Borrowers should demonstrate an ability and willingness to make payments before accessing additional benefits at taxpayer expense. Specifically, borrowers should be required to make a minimum of 12 on-time payments ($5 payments if they enroll in IBR and are not required to make a payment) after completing a resolution before regaining the right to use federal student aid programs or access deferment and forbearance options on existing loans.

Consistent Credit Reporting. Currently, a default is cleared from a borrower's credit report only after rehabilitation, but not after consolidation or when a borrower fully pays off his loan. There appears to be no meaningful justification for this inconsistency. We suggest that the government request that a default be removed from a borrower's credit report immediately after a borrower completes a resolution or fully pays off the balance on all loans still in default, regardless of how he does so. Put another way, borrowers who fully pay off their loans after defaulting and those who complete a resolution would be treated the same under this beneficial policy.

Conclusion. This report has shown that contrary to popular perceptions, default is usually not a permanent status. Moreover, it is not a total loss for taxpayers, as many defaulters eventually pay off their loans. That said, policies surrounding default exit are overly punitive in many respects. These policies are also inconsistent because borrowers often incur vastly different penalties depending on the pathway they take after default. Going forward, policymakers should make it a priority to rationalize laws and regulations governing default, while those in the media and research communities should update their characterizations of default in light of this information.

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Appendix A. Detailed Methodology

NCES conducted the Beginning Postsecondary Students Longitudinal Study: 04/09 (BPS:04/09), a nationally representative sample of students who began college during the 2003–04 academic year. BPS:04/09 follows up with members of that cohort three and six years after they begin college, so it can measure outcomes such as completion status and credential type. The data set contains 16,680 student observations.

Since the students surveyed in BPS:04/09 attended college, the federal student loan program has undergone several changes. Most importantly, Congress eliminated the Federal Family Education Loan (FFEL) Program, which offered bank-based, taxpayer-guaranteed loans to students. FFEL policies surrounding default differed in some ways from the policies discussed in "Individual Borrower Perspective" section, which are in place today. Other changes include the expansion of IBR options and a reduction in student loan interest rates. These changes may affect borrower behavior and balance evolution before and after default in ways for which our analysis cannot account.

The federal government keeps records of both direct and guaranteed federal student loans in the National Student Loan Data System (NSLDS). Due to privacy concerns, outside researchers have traditionally not had access to NSLDS data. However, NCES was able to extract NSLDS records for BPS:04/09 cohort members, match them to the existing survey data, and make the resulting data set available on a restricted-use basis.

Around 10,890 BPS:04/09 cohort members (65 percent of the sample) had identifiable records in NSLDS, excluding those with Parent PLUS loans only. The extracted NSLDS data cover a 154-month period between July 2003 and April 2016. The data set includes information on loan attributes, principal and interest balances, loan defaults, and the reasons borrowers exited default (if any). The data do not include actual payments made by borrowers, only changes in outstanding balances.

Most estimates presented in the report are weighted with the variable WTA000. The exceptions are estimates involving the sector of a borrower's school, which are weighted with the variable WTB000.

Analysis Sample

There are 2,670 borrowers in the sample who defaulted on at least one loan during the study period. This forms the sample for the analysis in "Aggregate Perspective" section. However, the sample base is unconventional for an analysis of default. First, the survey was designed to be representative of students who began postsecondary education in the 2003–04 academic year, not the population of defaulters. It is possible that defaulters as a whole may differ from the subset of defaulters captured in BPS:04/09.

One important difference, for example, is that a disproportionate share of borrowers in the data set entered loan repayment (and defaulted) during and immediately after the Great Recession. In addition, all federal student loans made today are originated by the federal government (Direct Loans), rather than originated by private financial institutions and guaranteed by taxpayers (FFEL loans). That was not the case during the study period: Only 18 percent of defaulters in our sample carried exclusively Direct Loans, while 42 percent had exclusively FFEL loans, and 39 percent owed a mixture of both.

Because the sample base of BPS:04/09 is a group of students who begin school at the same time, borrowers in the data may enter repayment and default on their loans at different times. Since the data set covers a fixed period of years, we have more years of data on borrowers who enter repayment at earlier dates. Similarly, we have more years of data on borrowers who default at earlier dates.

Of the 2,670 borrowers who default, 1,700 exited default at least once during the study period. However,

it is inappropriate to simply calculate the share of borrowers in our sample who ever exited default. This understates lifetime exit rates; some borrowers who will eventually exit default do not have their exits recorded because the exits occurred or will occur after data coverage ended in April 2016.

To address this, we must generally restrict our analyses to fixed periods of time. For example, instead of calculating the overall share of borrowers who exit default within the 13-year period covered by the data, we calculate the share of borrowers who exit default within five years of entering.

However, in doing so we are forced to exclude borrowers who first defaulted on their loans after April 2011, since the data coverage ends in April 2016. This reduces our sample size: While 2,670 individuals defaulted on a loan during the study period, only 1,580 defaulted on a loan five years or more before the end of the study period (i.e., before April 2011). Shorter time frames permit larger samples: A three-year default exit rate, for instance, allows for a sample size of 2,130.

Cropping the sample in this way introduces a potential source of bias: Borrowers who enter default at earlier dates (relative to when they started school) could differ from the population of defaulters as a whole. Unfortunately, there is no easy way to account for this; it is a caveat the reader should bear in mind.

Defining Default

We analyze default status at the borrower level rather than the loan level. A borrower is "in default" if he is in default on any loan. Therefore, default on a single loan is sufficient to enter default status. Conversely, to exit default a borrower must clear the default status on all loans; exiting default on one loan but not another is not considered a full default exit. In other words, if a borrower exits default on multiple loans at separate times, we use the latest exit for analysis purposes.

As they were not taken out by the students themselves, we exclude Parent PLUS loans from the analysis. We neither record Parent PLUS defaults nor include Parent PLUS loans as part of a borrower's total outstanding balance.

The default data for Stafford loans include the starting and ending dates for each default and the reason each default was resolved (rehabilitation, consolidation, full payoff, or discharge). The default data for non-Stafford federal loans, which are almost all Perkins loans, report the date the loan first entered default and the date a default status was last observed. This "last observation" may be the loan's last default exit (through rehabilitation, consolidation, etc.) or simply a flag to indicate that the loan was still in default as of April 2016.

We are unable to observe whether non-Stafford loans exited and reentered default between the date of first default and the date of last observation. For simplicity, we assume that defaulted non-Stafford loans remain in default throughout this period. As the vast majority of defaulted *Stafford* loans (90 percent) have just one default over the study period, we believe this is a reasonable assumption. Moreover, non-Stafford loans make up a small share of defaults (4 percent). Excluding non-Stafford loans from the analysis does not meaningfully affect our estimates of default exit rates, although it does slightly lower estimated rates of full payoff.

To calculate a defaulted borrower's outstanding balance, we simply sum the principal and interest on all outstanding federal loans (excluding Parent PLUS loans) regardless of whether those loans are in default. In uncommon cases, borrowers default on some loans but not others. We include all outstanding federal student loans in their balances because we are interested in the total financial burden facing each borrower.

Appendix B. Collection Fees and Borrower Requirements by Default Exit Scenario

Default Exit	Borrower Requirements	Collection Fee
Lump-Sum Payment	None	24.3% of principal and interest balance
Periodic Voluntary Payments	None	19.6% of each payment is deducted
Wage Garnishment	None/involuntary	19.6% of each payment is deducted
Tax Refund Offsets	None/involuntary	$17 is deducted from each tax refund offset
Settlement	Must pay full settlement amount in 90 days	24.3% fee is added to principal and interest, and then 20% of the entire new balance is waived
Consolidation, Three Payments	Must make three on-time payments equal to 1% of outstanding principal and interest balance	2.8% of total balance (added to balance of the new loan)
Consolidation, Income-Based Repayment	Must enroll in IBR	Lesser of $150 or 18.5% of balance (added to balance of the new loan)
Rehabilitation	Must make nine on-time payments in 10 months. Payments can be income based and as low as $5	19.6% of each of the nine monthly rehabilitation payments is deducted

Source: Information in this table comes from personal interviews with industry experts and information from the Department of Education and Government Accountability Office. See US Department of Education, Federal Student Aid, "Loan Servicing and Collection—Frequently Asked Questions," https://ifap.ed.gov/LoanServicingandCollectionInfo/LSCFAQ.html; and US Government Accountability Office, "Social Security Offsets: Improvements to Program Design Could Better Assist Older Student Loan Borrowers with Obtaining Permitted Relief," December 2016, https://www.gao.gov/products/GAO-17-45.

Appendix C. Total and Net Cost of Default on a $7,000 Loan

Default Exit	Cost of Loan, If Never Defaulted				Cost of Defaulted Loan				Net Cost of Default	Net Interest	Collection Fees	Months (Years) to Payoff
	Total	Principal	Interest	Fees	Total	Principal	Interest	Fees				
Lump Sum	$7,522	$7,000	$522	–	$9,937	$7,000	$992	$1,945	$2,415	$470	$1,945	34 (2.8)
Wage Garnishment	$8,165	$7,000	$1,165	–	$10,775	$7,000	$1,665	$2,110	$2,610	$500	$2,110	75 (6.3)
Tax Refund Offsets	$8,474	$7,000	$1,474	–	$8,975	$7,000	$1,873	$102	$501	$399	$102	94 (7.8)
Garnishment Plus Offsets	$7,879	$7,000	$879	–	$9,564	$7,000	$1,297	$1,267	$1,685	$418	$1,267	57 (4.8)
Settlement	$7,553	$7,000	$553	–	$7,949	$7,000	$992	–$42	$397	$439	–$42	36 (3)
Consolidation, Three Payments	$9,964	$7,000	$2,964	–	$10,933	$7,000	$3,642	$291	$969	$678	$291	180 (15)
Consolidation, IBR	$9,534	$7,000	$2,534	–	$10,378	$7,000	$3,187	$191	$845	$654	$191	155 (12.9)
Rehabilitation	$10,055	$7,000	$3,055	–	$10,836	$7,000	$3,827	$9	$781	$772	$9	185 (15.4)

Note: The net cost of default was calculated by comparing the total cost of paying off a defaulted loan to the amount the borrower would have paid if he had never defaulted and had repaid in equal monthly installments over the same time period. Calculations are based on a $7,000 loan at time of last payment with a 5 percent annual interest.
Source: Authors' calculations.

Notes

1. Robert Gebeloff, "Projections for Student Loan Defaults Are Terrifying. It's Time to Act.," *Washington Post*, January 22, 2018, https://www.washingtonpost.com/blogs/post-partisan/wp/2018/01/22/projections-for-student-loan-defaults-are-terrifying-its-time-to-act/.

2. Other researchers have conducted analyses on this data set, although they mostly did not focus on post-default outcomes. See Ben Miller, "Who Are Student Loan Defaulters?," Center for American Progress, December 14, 2017, https://www.americanprogress.org/issues/education-postsecondary/reports/2017/12/14/444011/student-loan-defaulters/; and Judy Scott-Clayton, "What Accounts for Gaps in Student Loan Default, and What Happens After," Brookings Institution, June 21, 2018, https://www.brookings.edu/research/what-accounts-for-gaps-in-student-loan-default-and-what-happens-after/.

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5. Charles A. Jeszeck, "Older Americans: Inability to Repay Student Loans May Affect Financial Security of a Small Percentage of Retirees," testimony before the Special Committee on Aging, US Senate, September 10, 2014, https://www.gao.gov/products/GAO-14-866T.

6. The now defunct Federal Family Education Loan program charged late fees. The Direct Loan Program, which has issued all new federal loans since 2010, does not charge late fees for past-due payments.

7. US Department of Education, Federal Student Aid, "Deferment and Forebearance," https://studentaid.ed.gov/sa/repay-loans/deferment-forbearance.

8. This report refers to the collection of plans that allow borrowers to make payments based on their incomes as IBR. The IBR plan is generally the most generous plan for new federal student loan borrowers as of 2014. While borrowers with loans from before that date may access other plans that set payments based on income, such as Pay As You Earn (PAYE) and the Revised Pay As You Earn (REPAYE) plan, the vast majority of new borrowers who use such plans will enroll in IBR.

9. Since ED reports statistics for Direct Loan and Federal Family Education Loan borrowers separately, there may be some slight double-counting of borrowers who are in default on both types of loans.

10. US Department of Education, Federal Student Aid, "Federal Student Loan Portfolio," https://studentaid.ed.gov/sa/about/data-center/student/portfolio.

11. Figures represent shares of dollars, not shares of borrowers. For more information, see US Department of Education, "Student Loans Overview: Fiscal Year 2018 Budget Proposal," May 23, 2017, https://www2.ed.gov/about/overview/budget/budget18/justifications/q-sloverview.pdf.

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19. Jason Delisle and Alexander Holt, "Why Student Loans Are Different: Findings from Six Focus Groups of Student Loan Borrowers," New America, March 11, 2015, https://www.newamerica.org/education-policy/policy-papers/why-student-loans-are-different/.

20. Navient, "Money Under 35: Navient's 2017 National Study on Financial Health of Young Adults Between the Ages of 22 and 35," 2017, https://navient.com/assets/about/who-we-are/Money-Under-35-report-2017.pdf.

21. After successfully clearing the default status on all loans, we consider a borrower to have exited default. In cases in which a borrower resolves the default on different loans at different times, we consider the borrower's last exit (the exit that brought him fully out of default) to be the point at which he exited default.

22. During the time period covered by this data analysis, student borrowers could pay off their defaulted loans with a credit card. Therefore, some borrowers who fully pay off their loans may still have the debt, but as credit card debt rather than student debt. Interviewees told us that ED has recently discontinued this policy or is planning to in the near future. For information on repaying defaulted student loans with a credit card, see US Department of Education, "PCA Procedures Manual: 2009 ED Collections Contracts," September 2009, http://www.studentloanborrowerassistance.org/wp-content/uploads/2013/05/2009-pca-procedures.pdf.

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24. Some borrowers who fully repay their debts do so through a settlement agreement under which the collection agency working on behalf of the federal government agrees to reduce the borrower's outstanding balance in exchange for a full payment. The data set for this analysis does not indicate whether a full payoff following default was part of a settlement. We therefore treat a full payoff as the borrower paying the full amount owed to bring his balance to $0. We discuss how settlements work in more detail in the second section of this report.

25. These statistics are calculated based on the outstanding balance of all a borrower's loans, not necessarily just those in default. Some borrowers default on only some of their loans and remain in good standing on others.

26. To a degree, reborrowing obscures the progress borrowers make on defaulted loans. Excluding reborrowers, the median defaulter pays down 14 percent of his balance within five years of his first default. The 25th percentile borrower fully pays off his loans, while the 75th percentile borrower sees his balance grow by 18 percent.

27. Excluding reborrowers, the median individual with less than $5,000 in debt at default pays down 75 percent of his outstanding balance within five years. For the other categories, these figures are 15 percent paid down ($5,000 to $10,000), 3 percent balance increase ($10,000 to $20,000), and 19 percent balance increase (more than $20,000).

28. Sample sizes are generally too small to analyze rehabilitation and consolidation separately.

29. This figure is slightly inflated by reborrowing. Excluding those who borrowed again after exit, the median borrower who rehabilitated or consolidated his loans reduced his balance by 3 percent in the five years after default. The median hard-exiter reduces his balance to zero after five years regardless of whether reborrowers are included.

30. For example, in 2009 the fee for consolidation out of default was 11.1 percent of current outstanding principal and interest. Today, that fee is generally no higher than 2.8 percent of outstanding balance. For more information on the amount of the previous and current consolidation fee, see US Department of Education, "PCA Procedures Manual"; and US Department of Education, Federal

Student Aid, "Loan Servicing and Collection—Frequently Asked Questions," https://ifap.ed.gov/LoanServicingandCollectionInfo/LSCFAQ.html.

31. A similar pattern holds when we ignore borrowers whose balances changed by less than 10 percent in either direction: Exiters and non-exiters are both still roughly evenly divided between those who reduce their balances and those who see their balances increase. However, non-exiters are more likely than exiters to see their balances change by less than 10 percent.

32. A small share of Group C borrowers fully paid off their defaulted loans and then borrowed again, causing their outstanding balances to rise above their original levels.

33. Seth Frotman and Rich Williams, "New Data Documents a Disturbing Cycle of Defaults for Struggling Student Loan Borrowers," Consumer Financial Protection Bureau, May 15, 2017, https://www.consumerfinance.gov/about-us/blog/new-data-documents-disturbing-cycle-defaults-struggling-student-loan-borrowers/.

34. This consists of $2.064 billion in tax refund offsets and $1.036 billion in payments through voluntary payments and wage garnishment. For tax refund figures, see US Government Accountability Office, "Social Security Offsets: Improvements to Program Design Could Better Assist Older Student Loan Borrowers with Obtaining Permitted Relief," December 2016, https://www.gao.gov/products/GAO-17-45. For voluntary payments and wage garnishment calculated from April 2016 through March 2017, see US Department of Education, Federal Student Aid, "Default Recoveries by Private Collection Agency," 2018, https://studentaid.ed.gov/sa/about/data-center/student/default.

35. Calculated from April 2016 through March 2017. See US Department of Education, "Default Recoveries by Private Collection Agency."

36. Some observers would argue that interest is not a cost to the borrower if the interest rate on the loan is below what the borrower could secure in the private market or below what he can earn. To understand this argument, consider how the interest accrued by deferring payments on a student loan can be financially advantageous, ignoring the other consequences of default. The annual fixed interest rate on for federal student loans issued in the 2016–17 academic year to undergraduates was 3.8 percent. If a borrower with such a loan can earn a greater return by investing in higher yielding securities, incurring interest costs on the loan can result in a net gain to the borrower. This is particularly the case if the borrower can invest in risk-free securities, such as US Treasury bills and notes, which yield more than the interest he accrues on his student loan.

37. The Government Accountability Office reported that in 2015, just $171 million in Social Security payments were offset. By comparison, tax refund offsets exceeded $2 billion that fiscal year. See US Government Accountability Office, "Social Security Offsets." Payments collected through wage garnishment were approximately $666 million between April 2016 and March 2017. See US Department of Education, "Default Recoveries by Private Collection Agency."

38. Kristin Blagg, "Underwater on Student Debt: Credit-Based Correlates and Consequences of Student Loan Default," Urban Institute, forthcoming.

39. We assume the borrower's loan balance is $7,000 at the time he last made a loan payment. At the point of default (nine months of nonpayments), the median loan balance for borrowers who exit default is $6,800 according to the BPS:04/09.

40. US Department of Education, Federal Student Aid, "Understand How Interest Is Calculated and What Fees Are Associated with Your Federal Student Loan," 2018, https://studentaid.ed.gov/sa/types/loans/interest-rates.

41. Default and collection policies are slightly different under a predecessor program, the Federal Family Education Loan program. Because all new loans as of 2010 are made under the Direct Loan Program, the policies we describe below apply for the vast majority of outstanding loans and all new loans going forward.

42. A borrower with a consolidation loan of less than $10,000 has his loan term set to 12 years.

43. The five conditions when accrued interest is capitalized on federal Direct Loans are at the end of the in-school grace period, after a forbearance, after a deferment, when a borrower using IBR no longer has a partial financial hardship, and when a loan becomes part of a consolidation loan, including to exit default. According to our interviews, interest is not capitalized when a borrower enters default or during default, although this would be permitted under the current regulations. For more information, see 34 C.F.R. § 685.202.

44. US Department of Education, Federal Student Aid, "What Is Default?," https://studentaid.ed.gov/sa/repay-loans/default.

45. Jeszeck, "Older Americans."

46. This value represents the $7,000 starting principal and 34 months of accrued interest at a 5 percent annual rate.

47. Interviewees told us that ED has recently discontinued this policy or is planning to in the near future. For information on repaying defaulted student loans with a credit card, see US Department of Education, "PCA Procedures Manual."

48. Multiple interviewees confirmed that ED's current policy is to charge a collection fee of 24.3 percent for this type of payment, although the number is not published in any widely available document.

49. 20 USC § 1087e; and 34 C.F.R. § 685.202(d)–(e).

50. The Department of Education's contracts with private collection agencies can be viewed at US Department of Education, Federal Student Aid, "Private Collection Agencies," https://studentaid.ed.gov/sa/about/data-center/business-info/contracts/collection-agency.

51. A borrower who repays a $7,000 loan with a 5 percent annual interest rate in equal installments over 34 months will pay a total of $7,522.

52. Equifax, "How Long Does Information Stay on My Equifax Credit Report?," https://www.equifax.com/personal/education/credit/report/how-long-does-information-stay-on-credit-report/.

53. Equifax, "How Long Does Information Stay on My Equifax Credit Report?"

54. To illustrate this example, assume the borrower makes a $2,000 payment once every six months. Interest continues to accrue during the intervening months, and a 19.6 percent fee is deducted from each of the periodic payments. Under this scenario, the borrower fully pays off the loan after 64 months, paying a total of $10,474.

55. A 24.3 percent fee assessed on the total balance is mathematically equivalent to charging a 19.6 percent collection cost taken out of each loan payment. That is, the fee applied to collection costs on each payment (19.6 percent) is equal to 24.3 percent of the total amount applied to interest and principal. Multiple interviewees confirmed that ED's current policy is to charge a collection fee of 19.6 percent per payment, although this number is not published in any widely available document.

56. For this calculation we include collections reported by ED that cover voluntary payments and wage garnishment and combine them with tax refund offsets reported in a Government Accountability Office study. See Government Accountability Office, "Social Security Offsets"; and US Department of Education, "Default Recoveries by Private Collection Agency."

57. This is the amount someone would earn from working 30 hours per week at the federal minimum wage. If the amount of the garnishment would leave a defaulted borrower with less than $218 in disposable pay per week, the amount of the garnishment is reduced to leave the borrower with at least that amount. For reference, only defaulted borrowers with annual wage incomes of around $12,000 or lower will see their amount of monthly wage garnishment reduced to leave them with at least $218. For more information, see 34 C.F.R. 34.19; and US Department of Labor Wage and Hour Division, "Minimum Wage," https://www.dol.gov/whd/minimumwage.htm.

58. 34 C.F.R. 34.3.

59. US Department of Education, Federal Student Aid, "Collections," 2018, https://studentaid.ed.gov/sa/repay-loans/default/collections; and 20 USC § 1095a.

60. Delisle and Holt, "Why Student Loans Are Different."

61. Multiple interviewees confirmed that ED's current policy is to charge a collection fee of 19.6 percent per payment, although this number is not published in any widely available document.

62. We assume a borrower will pay 5 percent of his total income in state taxes and 7.65 percent of his income in FICA taxes. For a borrower with a $25,000 annual income, these are equal to $1,250 and $1,913, respectively. In addition, the borrower pays $825 (effective tax rate 3.3 percent) in federal taxes. In total, the borrower pays $3,988 in state, FICA, and federal taxes, leaving him with a disposable annual pay of $21,012. His monthly disposable pay is $1,751, and the garnishment is 15 percent of that amount, or $263.

63. Equifax, "How Long Does Information Stay on My Equifax Credit Report?"

64. Because the borrower has collection fees deducted from each payment, it prolongs how long he repays his loan causing him to accrue additional interest. We find that $504 of the interest he pays on the loan is from this dynamic.

65. US Department of the Treasury, Bureau of the Fiscal Service, "Treasury Offset Program (TOP)," April 5, 2018, https://fiscal.treasury.gov/fsservices/gov/debtColl/dms/top/debt_top.htm.

66. US Government Accountability Office, "Social Security Offsets."

67. Authors' calculations. See US Government Accountability Office, "Social Security Offsets"; and US Department of Education,

"Default Recoveries by Private Collection Agency."

68. Authors' calculations based on interviews with industry experts.

69. The borrower has six tax refunds offset over those eight years, which fully repays the debt.

70. Equifax, "How Long Does Information Stay on My Equifax Credit Report?"

71. The $7,949 settlement amount is calculated as 80 percent of $9,937, which is $7,992 in principal and interest plus the $1,945 collection fee. Put another way, the settlement is 80 percent of ($7,992 + $1,945).

72. 20 USC § 1078–3.

73. Equifax, "How Long Does Information Stay on My Equifax Credit Report?"

74. US Department of Education, "Default Recoveries by Private Collection Agency."

75. 20 USC § 1078–3.

76. 20 USC § 1078–3.

77. Based on interviews with private collection agencies, who explained that the three on-time payments are calculated in this manner.

78. US Department of Education, "Loan Servicing and Collection."

79. However, the $219 fee is not the total cost of the fee. Since the fee is added to the borrower's balance, it contributes to the interest that accumulates on the loan. We count this interest as a cost of the fee. By the time this borrower pays off his loan, $72 of the total interest is due to the $219 fee, meaning the total cost of the fee is $291.

80. If the $150 fee exceeds 18.5 percent of his loan balance, it is reduced to that amount. In this scenario, a $150 fee is added to the loan balance. But like the fee in the three-payment consolidation scenario, this is not the total cost of the fee since adding $150 to the balance will contribute to the amount of interest that accrues overall. We count the interest that accrues on the fee as a cost of the fee. By the time the borrower pays off his loan, $41 in interest is due to the $150 fee, meaning the total cost of the fee is $191. For more information, see US Department of Education, "Loan Servicing and Collection—Frequently Asked Questions."

81. To calculate the total cost of default, we assume a borrower has a fixed, flat income of $35,000 and an exemption of $24,690 based on a household size of two. To calculate the net cost of default, we compare that amount to how much the borrower would have paid if he never defaulted and paid off the loan in the same period by making lower monthly payments.

82. US Department of Education, Federal Student Aid, "Benefits of Loan Rehabilitation," https://studentaid.ed.gov/sa/repay-loans/default/get-out.

83. 20 USC § 1078–6.

84. US Department of Education, "Default Recoveries by Private Collection Agency."

85. 20 USC § 1078–6.

86. US Department of Education, "Loan Servicing and Collection—Frequently Asked Questions."

87. The form is available at US Department of Education, "Loan Rehabilitation: Income and Expense Information," https://studentloans.gov/myDirectLoan/downloadForm.action?searchType=library&shortName=loanrehab&localeCode=en-us&_ga=2.25108734.51228729.1533132314-1114840532.1529604331.

88. 34 C.F.R. 685.211.

89. US Department of Education, "Loan Servicing and Collection—Frequently Asked Questions."

90. US Department of Education, "Loan Servicing and Collection—Frequently Asked Questions."

91. 34 C.F.R. 682.405.

92. US Department of Education, "Loan Servicing and Collection—Frequently Asked Questions."

93. For example, in the fiscal year 2008 budget, before IBR was available, ED projected a lifetime default rate of 16.7 percent for the Direct Loan Program. The same documents for the Fiscal Year 2019 budget show that ED projects the same lifetime default rate (16.7 percent) for loans issued in recent years. See US Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2008: Federal Credit Supplement*, https://www.gpo.gov/fdsys/pkg/BUDGET-2008-FCS/pdf/BUDGET-2008-FCS.pdf; and US Office of Management and Budget, *Budget of the U.S. Government, Fiscal Year 2019: Federal Credit Supplement*, https://www.gpo.gov/fdsys/pkg/BUDGET-2019-FCS/pdf/BUDGET-2019-FCS.pdf. In 2013, just 6 percent of borrowers in the Direct Loan Program enrolled in IBR (which

includes the IBR plan and the PAYE and REPAYE plans in this statistic), but by early 2018 the number had surged to 25 percent of borrowers. Authors' calculations based on US Department of Education, "Federal Student Loan Portfolio."

94. For example, ED pays private collection agencies a flat $1,710 fee per successful loan rehabilitation. See Federal Business Opportunities, "Debt Collection Service Award," https://www.fbo.gov/index?s=opportunity&mode=form&id=30d68208298f82a7114dfa117a83fd91.

95. A borrower who stops making payments on a $7,000 loan will accrue interest of $233 during the nine months it takes him to default. The proposed penalty is calculated as 5 percent of balance at default, or $362 in this scenario.