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Eliminating Interest Capitalization

On July 13, 2022, the U.S. Department of Education released a proposed rule that would eliminate all instances of interest capitalization not required by statute. This proposed rule follows the consensus reached by the negotiated rulemaking committee on affordability and student loans during last fall's session. The Pew Charitable Trusts (Pew) commends the department for taking this important step to slow balance growth and create a fairer repayment system for borrowers. Organizations from across the ideological spectrum have expressed concern about the effects of balance growth on borrowers' repayment outcomes. The department's proposal would eliminate the capitalization events that currently occur when a borrower enters repayment after leaving school, exits forbearance, defaults on their student loan, or exits most income-driven repayment plans. Pew research has found that existing rules around interest accrual and capitalization create significant balance growth for struggling borrowers, especially for those enrolled in income-driven repayment (IDR) plans.

As currently structured, interest capitalization often imposes a financial burden on borrowers who are already experiencing financial instability and have reached out to access tools created to help them. Unpaid interest accrues more quickly during periods of nonpayment, such as deferments, forbearances, or when borrowers are making lower payments in IDR plans. The addition of unpaid interest to borrowers' principal balances at the conclusion of such periods – as currently required – increases the amount subject to future interest charges and lessens the likelihood borrowers will be able to pay off their principal. While the ultimate effect of a single event of capitalization on balance growth can be small relative to the overall principal amount, successive usage or long durations of deferments and forbearances to pause payments can accelerate a small balance into a larger one. Pew research suggests that such balance growth can overwhelm and discourage borrowers from engaging with the repayment system. It is furthermore unclear what purpose capitalization ultimately serves in the portfolio. The department has previously suggested that "interest capitalization serves no purpose, other than to generate additional interest income" and that it is a common cause of borrower confusion.

Some capitalization events occur at friction points during the normal course of repayment for borrowers. For example, borrowers enrolled in an IDR plan are required to recertify their income each year to remain in their plan. Borrowers have reported significant issues with this process, including application delays and the rejection of incomplete applications without an opportunity to fix them. Regardless of the reason, borrowers unable to recertify their incomes on time will experience a

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capitalization event that will further spur balance growth. Research suggests that large numbers of borrowers miss their recertification deadline each year.

For these reasons, the elimination of capitalization events at such junctures will eliminate an unnecessary penalty on struggling borrowers and improve the clarity of the repayment system. We concur with the department's reasoning for eliminating capitalization when not required by statute and believe its prompt implementation would be a meaningful benefit for borrowers. As the department moves forward with this rule, it should also consider additional ways to reduce balance growth for borrowers, especially those enrolled in income-driven repayment plans.

Further Regulatory Action Required to Address Balance Growth
While the elimination of many capitalization events as now proposed by the department will help address balance growth to an extent, routine interest accrual often has a larger impact on principal balances than capitalization. This impact is seen most acutely for borrowers enrolled in IDR plans. Balance growth in IDR is largely the result of plan design –lowering monthly payments and extending repayment causes interest to accrue when payments are less than the monthly accrued interest. While this plan design often facilitates smaller monthly payments and thus lower rates of delinquency and default, over time it can lead to mushrooming balances that are far greater than their initial size. According to Pew modeling, much of these balances will be forgiven at the end of 20 or 25 years for low-income borrowers, raising questions about whether the psychological burden placed on borrowers via balance growth is ultimately justified given the lack of recaptured loan revenue.

The psychological impact of balance growth on borrowers was a common subject during focus groups conducted by Pew with student loan borrowers. Borrowers expressed concern that the long-term balance growth caused by IDR may not be worth the reduction in their monthly payment amount. A struggling borrower from Kansas City with a low balance remarked that they chose to not enroll in an IDR plan to avoid paying more in the long term, stating: "They called me and asked me if I wanted to make lower monthly payments, but I would have to pay longer, and I said no." Another borrower from Phoenix remarked that: "I'm never going to pay it off before I die anyways, so what's the point?" Other research has reported similar themes of surprising loan balances and hopelessness at the prospect of paying off loan balances that increase over time.

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Pew wrote to the department earlier this year about a proposal to establish a new IDR plan introduced during the same negotiated rulemaking session as the interest capitalization rule. According to our analysis, the design of the plan proposed by the department would generate large improvements in monthly payment affordability and address balance growth for borrowers making $0 payments via an interest subsidy covering the full amount of monthly unpaid interest. However, borrowers with calculated payments above the $0 threshold would receive no interest subsidy, creating a large benefits cliff that will impact moderate income borrowers. As the department drafts a new IDR plan for public comment, it should address these concerns by considering the following measures:

- **Expand interest subsidies.** In addition to subsidizing the unpaid interest of borrowers who make $0 payments—those with incomes below 150% of the federal poverty level guideline (or potentially higher) - future IDR plans should expand interest subsidies to payments above this amount. Expanding interest subsidies to more borrowers—in full or in part—would help address the negative effects of mushrooming loan balances. A subsidy resembling REPAYE's current structure where borrowers with unsubsidized loans receive a subsidy for half of their monthly unpaid interest could provide a foundation for an expanded subsidy in future IDR plans.

- **Enhance payment tracking:** The Government Accountability Office (GAO) recently identified significant problems with the process for counting qualifying payments, which are required to verify eligibility for loan forgiveness under the current suite of IDR plans. Proposals to accelerate the amount of time until low-income borrowers receive forgiveness warrant further consideration to potentially address the psychological burdens of long-term balance growth and ensure that servicers' resources are more efficiently allocated over time. Additionally, the department could also explore whether incremental forgiveness is administratively feasible. Regularly forgiving a portion of borrower's balances at shorter intervals, perhaps as an incentive for making a certain number of payments, could help maintain their engagement with the repayment system and provide policymakers and stakeholders with a fuller picture of the federal student loan portfolio. It may also act as an ongoing audit to ensure that servicers are accurately counting borrowers' qualifying payments.

- **Continued progress towards implementing the Fostering Undergraduate Talent by Unlocking Resources for Education (FUTURE) Act:** The department can take steps beyond the regulatory process to help borrowers be more successful in repayment. While the department's proposed rule would eliminate interest capitalization associated with exiting most IDR plans, issues recertifying IDR plan enrollment can still cause other problems for borrowers —including

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temporary enrollment in the Standard Repayment Plan where they may face higher payments not calculated using their income. Once effectively implemented, the FUTURE Act will eliminate this friction point for borrowers who opt-in to having their relevant tax information shared with the department. The success of this implementation could be used as a foundation for more automaticity in the repayment system.

Conclusion

Pew would like to thank the Department of Education, as well as the participants in the fall 2021 negotiated rulemaking, for its efforts to end the instances of interest capitalization possible within its regulatory purview. The department has recognized that interest capitalization can be a significant hinderance to successful repayment for many student loan borrowers, especially low-income borrowers most at risk of delinquency and default. We urge the department to continue to look for ways to limit balance growth, including negative amortization in IDR plans, in its future IDR rulemaking.