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Student Loan Default Has Serious Financial Consequences

Department of Education and Congress can do more to help borrowers repay

Overview

As of December 2019, about 43 million Americans held federal student loans, and the education financing system is under growing pressure as more borrowers struggle to repay, a problem compounded by the complexity of the repayment process.[1] The U.S. Department of Education reports that about 20 percent of borrowers are in default—typically defined as having gone at least 270 days without a payment—and more than a million loans go into default each year.[2] And although recent research indicates that many borrowers eventually are able to get their loans current, some default again, even multiple times: twenty-five percent of people who restored their loans to good standing defaulted again within five years.[3]

Most federal student loans are managed by servicers—third-party companies under contract to the Department of Education—that perform functions such as collecting payments and helping borrowers select repayment plans and access tools for pausing payments. After a borrower defaults, the servicer transfers the loan to the Department of Education, which generally reassigns it to a private agency to collect the debt.

Failure to repay student loans can have serious financial consequences for borrowers, including collection fees; wage garnishment; money being withheld from income tax refunds, Social Security, and other federal payments; damage to credit scores; and even ineligibility for other aid programs, such as help with homeownership. These outcomes can also adversely affect a family's financial security.

Borrowers who default face a range of harmful outcomes

Loss of access to repayment tools and other federal programs

When borrowers are in default, their loans continue to accrue interest. Further, borrowers who had been enrolled in income-driven repayment plans—which tie monthly payments to borrowers' incomes and family sizes, and offer loan forgiveness after 20 to 25 years of qualifying payments—lose access to these programs and their benefits while in default. And borrowers in default are ineligible for additional federal student aid.

Collection fees that increase borrowers' costs

The Department of Education and collection agencies can charge borrowers who default as much as 25 percent of principal and interest while interest continues to accrue. And government agencies and debt collectors may also charge fees associated with wage garnishment and U.S. Treasury Department withholdings, known as offsets, from borrowers' Social Security, federal income tax refunds, or other federal payments (see Repayment, below, for more information).

Damaged credit—from delinquency or default—for up to seven years

Servicers are required to report loans that are in default or more than 90 days delinquent to the major national credit bureaus. These notations remain on borrowers' credit reports for up to seven years.

Research suggests that, on average, student loan borrowers' credit scores—many of which may already be low—decline by 50 to 90 points in the period leading up to a student loan default, potentially a result of delinquent payments and possibly indicating that borrowers who default on student loans are falling behind on other bills as well. And although these individuals' credit scores can recover somewhat shortly after they enter default, borrowers with poor credit will pay more for or have difficulty obtaining credit cards, home or car loans, and other consumer credit and insurance products for several years.

Jeopardized employment

Some borrowers who default--depending on their state of residence and loan type--are at risk of having their driver's or professional licenses suspended, compromising their ability to continue working. Similarly, military service members, contractors, and federal employees with delinquent or defaulted debt can be denied security clearances, duty stations, and promotions.

Exiting default can be complicated and confusing

The options for getting out of default can present barriers for many borrowers.

Rehabilitation

Borrowers in default can return their loans to good standing through "rehabilitation," in which they make nine on-time payments based on their incomes within 10 consecutive months. Borrowers who cannot afford these payments may be able to make, at the discretion of the debt collector, lower alternative monthly "reasonable and affordable" payments that take expenses as well as income into account. Rehabilitation can typically be used only once.

When loans are successfully rehabilitated, the defaults are resolved on the borrowers' credit histories, although the delinquencies remain, and the loans transfer back from the debt collector to a servicer and regain eligibility for income-driven plans. However, for some borrowers, the "reasonable and affordable" payment made while in rehabilitation might be less than the income-driven payment offered when they return to good standing, which could lead to confusion and potentially further delinquency.

Consolidation

This process allows borrowers to roll their existing federal student loans into a new loan, which they are then responsible for repaying. To consolidate a defaulted loan, borrowers must either make three on-time monthly payments on the defaulted loan or enroll in an income-driven repayment plan. Borrowers generally can consolidate loans only once, and the default remains on their credit histories.

Repayment

Borrowers may either voluntarily repay all or a portion of their defaulted loans or be compelled to do so through a variety of mechanisms. For instance, the Department of Education can direct the Department of the Treasury to withhold money from various federal payments, such as the borrower's federal income tax refunds, including the refundable portion of tax credits, and Social Security to offset a defaulted student loan. Similarly—and sometimes simultaneously—the entity collecting a loan can garnish up to 15 percent of the borrower's wages.

Like borrowers who consolidate or rehabilitate their loans, those who are subject to wage garnishment or federal offsets also may incur collection fees. Researchers have noted that differences in fees across collection methods can create confusion for borrowers and that collections can damage family financial security.

Discharge

In some circumstances—including death; disability; school closure; or certain misconduct, misrepresentation, or deception on the part of a school—the government may also release the borrower from the obligation to repay a defaulted loan. Unlike most other types of debt, federal student loans can rarely be discharged in bankruptcy.

The Department of Education and Congress can do more to help borrowers avoid default

Higher education is among the most effective strategies available to bolster families' economic security. A focus on the significant challenges facing current borrowers and improvements to the student loan repayment system to help them avoid default are critical.

Pew research points to three actions that the Department of Education and Congress could take to boost repayment success among struggling borrowers:

- **Identify at-risk borrowers** before they are in distress—in particular, by using risk indicators such as borrowers missing payments early, repeatedly suspending payments, and having previously defaulted.
- **Provide loan servicers with resources and comprehensive guidance** on how to prioritize interactions and engagement with high-risk borrowers.
- **Continue to eliminate barriers to enrollment in affordable repayment plans** to build upon the Fostering Undergraduate Talent by Unlocking Resources for Education (FUTURE) Act. The act authorizes data sharing between the Internal Revenue Service and the Department of Education to streamline burdensome and duplicative income verification requirements for enrolling in income-driven plans. If effectively implemented, the act is a step in the right direction, but policymakers can do more to restructure the student loan repayment system, such as simplifying the process for direct and targeted outreach to those borrowers most at risk for—or already facing problems with—delinquency and default.

These changes should be implemented in conjunction with clear and consistent repayment-management rules for servicers and other Department of Education contractors and with oversight mechanisms to ensure that those rules are successfully applied.

Endnotes

1 Office of Federal Student Aid, "Federal Student Loan Portfolio," U.S. Department of Education, accessed Feb. 24, 2020, https://studentaid.ed.gov/sa/about/data-center/student/portfolio. The total student loan holders figure includes direct and Perkins loans and loans from the Federal Family Education Loan (FFEL) program.

2 Ibid.; Office of Federal Student Aid, "Default Rates," U.S. Department of Education, accessed Feb. 24, 2020, https://studentaid.ed.gov/sa/about/data-center/student/default. The total borrowers in default figure includes direct and FFEL loans, and borrowers with both types of loans may be counted more than once. Although default technically occurs after 270 days of missed payments, these figures measure default after 360 days.

3 Unless otherwise noted, all data in this fact sheet are cited in or from The Pew Charitable Trusts, "Student Loan System Presents Repayment Challenges" (2019), https://www.pewtrusts.org/en/research-and-analysis/reports/2019/11/student-loan-system-presents-repayment-challenges.

For further information, please visit:

pewtrusts.org/studentborrowersuccess

Contact: Regan Fitzgerald, senior associate, government relations
Email: rfitzgerald@pewtrusts.org

Contact: Esther Rege Berg, officer, communications
Email: eberg@pewtrusts.org

Project website: pewtrusts.org/studentborrowersuccess