



UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF POSTSECONDARY EDUCATION

Issue Paper #3: Interest Capitalization
Session 1: October 4-8, 2021

Issue:	Eliminate interest capitalization for non-statutory capitalizing events
Statutory cites:	§428H(e)(2) of the Higher Education Act of 1965, as amended
Regulatory cites:	34 CFR 685.209(a)(2)(iv), 685.209(c)(2)(iv), 685.202(b)(4), 685.202(b)(3), and 685.220(f)(3)

Summary of issues: Section 428H(e)(2) of the Higher Education Act of 1965, as amended, provides that interest capitalization occurs when any accrued, unpaid interest becomes part of the principal balance of a borrower's loan. Capitalization is triggered by designated "capitalizing events." Once interest is capitalized, it begins to accrue interest at the rate applicable to the loan. This ultimately increases the overall balance of the loan and typically increases the amount the borrower must repay. When capitalization occurs, borrowers see balances rise faster as interest accrues on interest.

Interest capitalization is not a common practice across other consumer financial products, at least in part because Federal student loans afford more opportunities to pause or reduce payments. Auto loans do not provide common occurrences for interest capitalization. Mortgage interest typically only capitalizes with certain modifications. In addition, there are federal and state laws that prohibit capitalization of interest on certain consumer financial products and under certain circumstances. While student loans are a very different kind of financial product, capitalization can be a frustrating experience for borrowers who are confused as to what triggered the capitalization or surprised by the higher amount owed.

The Department has identified the following capitalizing events in regulation where we are proposing to eliminate interest capitalization on a more permanent basis:

- Failure to recertify enrollment on an income-driven repayment (IDR) plan — Borrowers are required to recertify their participation in any income-driven repayment plan annually, but ED data presented at a 2015 negotiated rulemaking session indicates that over half of borrowers in an IDR plan fail to recertify on time. Additionally, researchers have suggested that recertification is a significant barrier for lower income borrowers.¹
- Leaving an Income-Contingent Repayment (ICR) plan (PAYE, REPAYE, ICR) — While borrowers switching across other types of repayment plans, such as standard and graduated, do not have their interest capitalized, ICR borrowers do.

¹ <https://www.urban.org/urban-wire/structural-changes-student-loan-repayment-could-make-forgiveness-work-better-struggling-borrowers>

Interest Capitalization 2

- Negative amortization under the ICR plan — Under the original ICR plan, borrowers whose payments do not cover accumulating interest see that interest capitalize annually until the capitalized interest reaches 10 percent or more of the original principal balance. Unpaid interest does not capitalize under the other IDR plans unless the borrower leaves those plans.
- Exiting forbearance — Borrowers often exercise forbearances because they are unable to afford their payments for a short period of time. Interest capitalization at the end of a forbearance period penalizes borrowers who are seeking to get on track.
- Entering repayment — When borrowers' loans enter repayment for the first time, interest currently capitalizes when borrowers' grace periods end.
- Default — For Direct Loan and ED-held FFEL loans the Department does not currently capitalize interest when a borrower defaults or exits default (unless the borrower consolidates to get out of default). For all commercially held FFEL loans, the guaranty agency managing a FFEL borrower's defaulted loan capitalizes the interest when it pays a default claim to a lender.

Solution: The Department is concerned that interest capitalization can significantly increase what a borrower owes and extend the time it takes to repay their loans. And there may be many circumstances in which borrowers are not even aware that capitalization may occur. The Department is proposing to eliminate capitalization events where it has the authority to do so, which are the instances identified above. In circumstances where interest capitalization is required by statute, the Department cannot end capitalization for borrowers. Instances where capitalization is required in statute include when the borrower exits a deferment period and when a borrower leaves the Income-Based Repayment plan.

Proposed Regulations:

To assist the Committee in discussing these issues, the Department is providing draft revisions to the regulatory language for the Direct Loan Program, incorporating the Department's proposals.

(Conforming changes will be made to FFEL regulations.)

§ 685.202 Charges for which Direct Loan Program borrowers are responsible.

(b) *Capitalization.* (1) The Secretary may add unpaid accrued interest to the borrower's unpaid principal balance. This increase in the principal balance of a loan is called "capitalization."

~~(2) For a Direct Unsubsidized Loan or a Direct Unsubsidized Consolidation Loan that qualifies for a grace period under the regulations that were in effect for consolidation applications received before July 1, 2006, or for a Direct PLUS Loan, the Secretary may capitalize the unpaid interest that accrues on the loan when the borrower enters repayment.~~

~~(23) Notwithstanding § 685.208(l)(5) and § 685.209(d)(3), for a Direct Loan not eligible for interest subsidies during periods of deferment, and for all Direct Loans during periods of forbearance, the~~

Interest Capitalization 3

Secretary capitalizes the unpaid interest that has accrued on the loan upon the expiration of the deferment ~~or forbearance~~.

~~(4) Except as provided in paragraph (b)(3) of this section and in § 685.208(l)(5), and § 685.209(d)(3), the Secretary annually capitalizes unpaid interest when the borrower is paying under the alternative or income-contingent repayment plans and the borrower's scheduled payments do not cover the interest that has accrued on the loan.~~

~~(5) The Secretary may capitalize unpaid interest when the borrower defaults on the loan~~

§ 685.209 Income-contingent repayment plans.

~~(a)(2)(iv)(A) Except as provided in paragraph (a)(2)(iii) of this section, accrued interest is capitalized —~~

~~(1) when a borrower is determined to no longer have a partial financial hardship; or~~

~~(2) At the time a borrower chooses to leave the Pay As You Earn repayment plan.~~

~~(B)(1) The amount of accrued interest capitalized under paragraph (a)(2)(iv)(A)(1) of this section is limited to 10 percent of the original principal balance at the time the borrower entered repayment under the Pay As You Earn repayment plan.~~

~~(2B) After the amount of accrued interest reaches the limit described in paragraph (a)(2)(iv)(B)(1) of this section, interest continues to accrue, but is not capitalized while the borrower remains on the Pay As You Earn repayment plan.~~

...

~~(b)(3)(iv) **Limitation on capitalization of interest.** If the amount of a borrower's monthly payment is less than the accrued interest, the unpaid interest is capitalized until the outstanding principal amount is 10 percent greater than the original principal amount. After the outstanding principal amount is 10 percent greater than the original amount, interest continues to accrue but is not capitalized. For purposes of this paragraph, the original amount is the amount owed by the borrower when the borrower enters repayment.~~

...

~~(c)(2)(iv) Any unpaid accrued interest is capitalized at the time a borrower leaves the REPAYE plan.~~