Student Aid Policy Analysis

The Economic Hardship Deferment and the 20/220 Rule

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EXECUTIVE SUMMARY

This report summarizes the issues surrounding the elimination or retention of the 20/220 rule for economic hardship deferments. Elimination of the 20/220 rule would mainly affect medical and dental school students. The impact is mainly financial, since the students could still elect to defer repayment of principal and interest through a forbearance. In addition, borrowers have a new repayment option starting July 1, 2009, the income-based repayment plan, which caps monthly payments based on a percentage of the borrower's discretionary income. This makes the monthly payments affordable for most borrowers, typically requiring less than 10% of gross income to be devoted to repaying debt. Any borrower who was previously eligible for an economic hardship deferment under the 20/220 rule will be eligible for income-based repayment.

INTRODUCTION

The College Cost Reduction and Access Act of 2007 (CCRAA) removed the 20/220 rule from the eligibility standards for economic hardship deferment by striking section 435(o)(1)(B) of the Higher Education Act of 1965, effective October 1, 2007. However, the US Department of Education allowed the 20/220 rule to remain in the regulations until the issuance of final regulations for CCRAA.[1] Those regulations[2] are dropping the 20/220 rule, effective July 1, 2009. However, Senators Burr, Alexander, Roberts, Dodd and Coburn have introduced S.646 to reintroduce the 20/220 rule.

The original 20/220 rule allowed an economic hardship deferment when the monthly loan payments exceeded 20% of discretionary income and discretionary income was less than 220% of the greater of the poverty line for a family of two and the minimum wage. CCRAA substituted 150% of the poverty line for the family size for 100% of the poverty line for a family of two in the definition of discretionary income and in the 220 standard.

During an economic hardship deferment the federal government pays the interest on subsidized Stafford loans and on the portion of a consolidation loan that repaid a subsidized Stafford loan. Otherwise the interest is the responsibility of the borrower and is capitalized if the borrower elects to defer payments of principal and interest. This is in contrast with forbearances, where the interest on all loans, including subsidized Stafford loans, is the responsibility of the borrower and

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[1] Letter to Rep. McKeon from Terrell L. Halaska dated October 29, 2007.
[2] Federal Register 73(206):63234-63235, October 23, 2008

subject to capitalization if deferred. The economic hardship deferment and forbearances each have a 3-year limit.[3] [4]

This mainly matters to medical and dental school students, who are ineligible for an in-school deferment during their internship, residency and fellowship. Since medical and dental school students typically have debt-to-income ratios ranging from 2:1 to 7:1 during this time period, they are unable to make fully-amortized monthly loan payments and need temporary repayment relief. Many previously qualified for an economic hardship deferment under the 20/220 rule and will not qualify after July 1, 2009 when it is no longer effective.[5]

However, the new income-based repayment plan (IBR) becomes effective on July 1, 2009. IBR caps monthly payments at 15% of the amount by which income exceeds 150% of the poverty line for the family size. IBR also provides a limited interest subsidy benefit for subsidized Stafford loans and the portion of a consolidation loan that repaid subsidized Stafford loans. The federal government pays the unpaid interest for up to three years when the monthly payment under IBR is less than the interest that accrues. After that point any unpaid interest is deferred and will be capitalized when the borrower no longer qualifies for IBR. Borrowers who elect to pursue full-time public service careers while their loans are in the Direct Loan program will have the remaining balance forgiven after ten years of public service.

Any borrower who qualified for an economic hardship deferment under the 20/220 rule will qualify for income-based repayment.

PRACTICAL DIFFERENCES

The main practical differences from a borrower's perspective are as follows:

1. The federal government pays the full amount of interest on subsidized Stafford loans under the economic hardship deferment, while the federal government pays only the unpaid interest on subsidized Stafford loans under income-based repayment.

2. Under the economic hardship deferment borrowers can defer repayment of all principal and interest (interest on unsubsidized loans is capitalized), while under the income-based repayment plan they have to make small monthly payments. For most medical and dental school students the monthly payments will be less than 10% of their gross monthly income.

IBR makes federal student loan debt affordable by pegging the payments to income, not debt levels. Some medical and dental school students will prefer to defer the repayment obligation entirely until their income is much higher, even though that increases their costs because of the

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[3] During the debate over the CCRAA, a proposal to increase the deferment period from 3 to 6 years was ultimately unsuccessful.

[4] The medical resident forbearance is not limited to 3 years and can be renewed annually for as long as the borrower is a resident. The 3-year limit does, however, apply to fellowships.

[5] Borrowers will be able to continue a deferment that started before July 1, 2009 beyond that date for up to 12 months. This reflects the fact that deferments are granted in one-year increments. No subsequent one-year deferments will be granted based on the 20/220 rule after the borrower’s current economic hardship deferment expires.

capitalization of unsubsidized interest. Borrowers who feel the need to fully defer repayment of principal and interest would have to resort to a forbearance, which has a 3 year limit. Many medical and dental school students work around this limitation by consolidating their loans just before the forbearance expires. A consolidation loan, as a new loan, is eligible for a new set of forbearances.

Perkins loan borrowers are not eligible for income-based repayment unless they elect to consolidate their loans, in which case they lose some of the favorable repayment benefits available to Perkins loan borrowers.

KEY ISSUES

In essence, the debate over the elimination of the 20/220 rule is focused on two issues:

- the repayment trajectory while medical and dental school students are in a residency, internship or fellowship; i.e., whether they should have access to a full or partial deferment of principal and interest

- the greater value (cost) of interest benefits under the economic hardship deferment as compared with income-based repayment and the added impact of capitalized interest on the total cost of a loan

Ultimately the debate is probably motivated more by the money than the repayment trajectory. After all, someone earning $56,500 can easily afford to pay $503 a month under IBR, about 8.9% of gross income.[6]

Deferments are very expensive to the federal government.[7] [8] One could ask why the federal government should pay interest on loans to a subset of the student population that will ultimately be much better compensated than all other subsets of the student population.[9] Also, if the 20/220

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[6] $56,500 is the maximum income that would qualify for an economic hardship deferment under the 20/220 rule for a borrower with $150,000 in medical school loans and a family size of 1 using the 2009 poverty line and a 6.8% interest rate. After the 20/220 rule is eliminated, $16,236 is the maximum income that would qualify for an economic hardship deferment for this debt level. The $503 monthly payment under IBR for $56,500 in income compares with a $1,726 monthly payment under standard 10-year repayment. The maximum income eligible for IBR for a borrower with $150,000 in loans is $154,300. Although the details vary according to debt levels and family size, more borrowers will qualify for IBR than previously qualified for an economic hardship deferment.

[7] The US Department of Education estimates that the economic hardship deferment costs the federal government $1.1 billion per decade.

[8] Assuming $25 billion in new subsidized Stafford loans per year, an average life per loan dollar in an in-school or grace period of 33 months and an interest rate of 6.8%, just the in-school deferment on a year's worth of subsidized Stafford loans costs $4.675 billion. (The interest rates on subsidized Stafford loans for undergraduate students are undergoing a phased-in reduction, with 6.0% in 2008-09, 5.6% in 2009-10, 4.5% in 2010-11, 3.4% in 2011-12, and back to 6.8% in 2012-13 unless Congress acts to extend the 3.4% rate. The interest rate for graduate and professional students remain at 6.8%.) That's enough to increase the maximum Pell Grant by more than $600. Throw in the subsidized interest from other deferments and you get about a $700 increase in the maximum Pell Grant.

[9] The author of this report has advocated for eliminating subsidized interest on all federal education loans and redirecting the savings to the Pell Grant program, as the Pell Grant program is better targeted according to financial need than other student aid programs. Since most students defer repayment on their loans, subsidized interest provides a financial benefit to the students after they've graduated, not when they need it to pay college bills. Thus

rule were retained, medical and dental school students could stack the economic hardship deferment and IBR to get six years of subsidized interest instead of the current three-year limit.

Medical and dental school students have grown accustomed to the use of deferments, and may view a requirement to make payments during the residency and internship (notwithstanding the availability of forbearances) as putting pressure on their take home pay. This may, in turn, put pressure on hospitals to increase the amounts they pay residents and interns to compensate.

Private student loans may also be a contributing factor. When Congress introduced the Grad PLUS loan on July 1, 2006, many graduate and professional students shifted their borrowing from private student loans to federal. But there may still be some medical and dental school students who have private student loans from a few years ago, or who did not switch immediately to the Grad PLUS loan, or who are ineligible for the Grad PLUS loan due to an adverse credit history. They may need to rely on their take-home pay to make payments on their private student loan debt. Sallie Mae's switch from the Signature private student loan product to their new Smart Option private student loan might also add some pressure, since the Smart Option loan requires payments of at least the interest during any in-school or forbearance period while the Signature loan allowed for interest to be deferred and capitalized.

TOOLS FOR EVALUATING IMPACT

FinAid's economic hardship deferment calculator[10] has been updated to allow borrowers to control whether the 20/220 rule is used in evaluating eligibility for the economic hardship deferment. It will default to including the rule through June 30, 2009 and to excluding the rule on or after July 1, 2009.

FinAid also provides an income-based repayment calculator[11] which can be used to evaluate the benefits of income-based repayment. In particular, it includes the capability of evaluating an income jump on the repayment plan.

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subsidized interest has no measurable impact on access by at-risk populations to a higher education. Eliminating subsidized interest would eliminate the difference between deferments and forbearances.

[10] www.finaid.org/calculators/economichardship.phtml

[11] www.finaid.org/calculators/ibr.phtml