Statement before the House Committee on Appropriations
Subcommittee on Labor, Health and Human Services, Education, and Related Agencies
On "Protecting Student Borrowers: Loan Servicing Oversight"

Servicing Federal Student Loans

How Simplification Can Help Borrowers and Protect Taxpayers

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Good morning, Chairwoman DeLauro, Ranking Member Cole, and distinguished Members of the Subcommittee. Thank you for the opportunity to testify today on servicing the federal student loan portfolio.

My name is Preston Cooper and I am a research analyst in higher education policy at the American Enterprise Institute (AEI), a nonprofit, nonpartisan public policy research organization based here in Washington, DC. My comments today are my own and do not reflect the views of AEI, which does not take institutional positions on issues.

Background on Federal Student Loans and Servicing

The federal student loan program currently has an outstanding portfolio of $1.4 trillion in student loans distributed among 43 million borrowers.[1] Roughly $94 billion in new federal loans are disbursed every year.[2] The Department of Education (ED) directly manages 86% of the portfolio, amounting to $1.2 trillion. (The remaining $200 billion is federally guaranteed but owned by private banks, and thus is not managed by the federal government.)[3] ED currently contracts with nine servicers to administer and collect payments on federally managed student loans. As of September 2018, the Pennsylvania Higher Education Assistance Authority (PHEAA) was the largest servicer by loan volume ($344 billion), followed by Great Lakes ($246 billion), and Navient ($223 billion).[4]

ED requires servicers to manage its student loan portfolio because a single loan can move through various statuses. Payments are not due while a borrower is in school, or during a six-month grace period following enrollment. Once a loan comes due, borrowers can choose from a number of repayment plans, ranging from a ten-year standard plan with the same payment every month to an array of income-based repayment plans, where payments rise and fall with the

borrower's income. A borrower can pause payments if her servicer grants her a deferment or forbearance, but if a borrower fails to make her monthly payment and does not have a deferment or forbearance, her loan will become delinquent. After she is delinquent for 270 days, her loan goes into default and transfers from her servicer to a collections agency, which can initiate extraordinary collection measures such as wage garnishment and seizure of tax refunds. Borrowers who default also have to pay additional fees, which can run to thousands of dollars.[5]

Default is not a desirable outcome for either borrowers or taxpayers, so ED has set up incentives for servicers to help borrowers avoid default. When allocating new loans to the nine servicers, ED takes into account the percentage of the servicer's current borrowers that are delinquent on their loans. The compensation structure for servicers also rewards those who keep borrowers current on their loans: a servicer receives $2.85 per month for each borrower who is in current repayment, but just $0.45 per month for each borrower who is severely delinquent.[6]

Despite these incentives, 7.2 million borrowers with federally managed loans are currently in default, while another 3.3 million are delinquent. Another 2.7 million borrowers are in forbearance, a status in which they are not required to make payments, but may see their balances grow due to interest accumulation.[7] Finally, roughly a million borrowers have signaled their intention to work towards Public Service Loan Forgiveness (PSLF), but many have complained about their perceived inability to get relief, an issue for which servicers often get the blame.[8]

While there is always room for servicers to improve, there is also scope for policymakers to reform the federal student loan program itself in order to reduce confusion, errors, and undesirable loan outcomes. Currently, the federal student loan program offers several different repayment plans, runs multiple and overlapping loan forgiveness programs, and provides

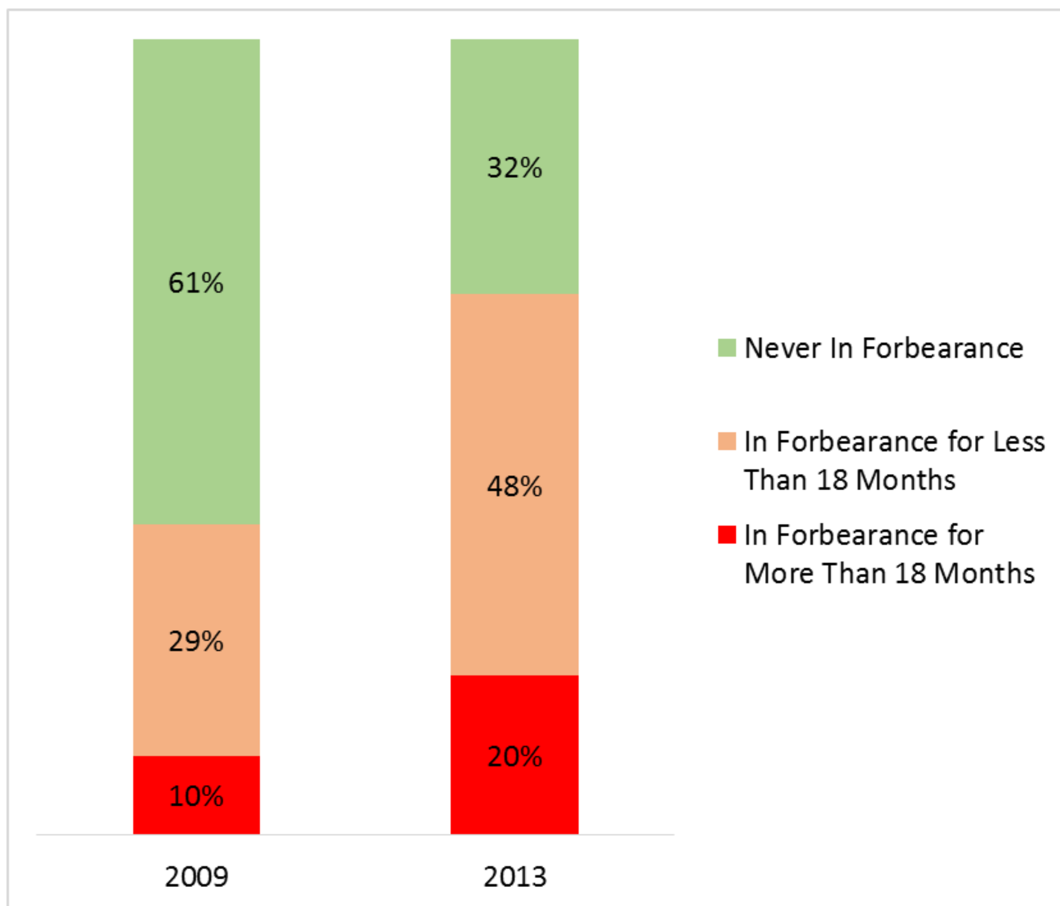
numerous opportunities for borrowers to avoid paying their loans. Federal student loans are one of the most complex consumer financial products that exist in the United States. To improve servicing, and therefore to improve outcomes for borrowers, policymakers should start with simplification.

Too Many Student Borrowers Aren't Making Payments

High rates of delinquency and default represent major problems with the student loan program. But the program also offers harbors for student borrowers to avoid making payments on their loans while not going delinquent. Borrowers may request a deferment on their loans for many reasons including unemployment, economic hardship, military service, or going back to school. But if a borrower does not fall into one of these categories, she is also legally entitled to request a *discretionary forbearance*. Under a discretionary forbearance, the borrower may pause payments on her loans for any reason, or no reason at all. A borrower can stay in forbearance for up to three consecutive years.[9]

While there is merit to the idea of giving borrowers facing financial difficulties the option to temporarily pause payments, the use of forbearance has extended far beyond that narrow purpose. There are currently 1.5 million Direct Loan borrowers in discretionary forbearance, compared to just 240,000 in an unemployment or economic hardship deferment.[10] The Government Accountability Office (GAO) estimates that 68% of borrowers who entered student loan repayment in 2013 have used a forbearance at least once, and 20% of borrowers have been in a forbearance status for more than eighteen months (Figure 1).[11] These figures are far higher than we would expect if student borrowers were using forbearance only as a tool to help them through temporary hardships.

Figure 1: Student Loan Borrowers Using Forbearance, by Year Entered Repayment



Source: Government Accountability Office.

Excessive use of forbearance has negative ramifications for borrowers, taxpayers, and our higher education system. First of all, interest continues to accrue on loans while a borrower is in forbearance. At today's interest rates, a borrower with $30,000 in debt who spends three years in forbearance will owe over $4,500 more once the forbearance has expired. Moreover, one of the student loan program's key accountability measures for colleges, the Cohort Default Rate (CDR), treats borrowers in forbearance as if they were in positive repayment status, despite not currently making payments on their loans. In 2016, GAO estimated that long-term forbearances

caused 265 institutions to avoid penalties under CDR.[12] In other words, because of excessive forbearance use, numerous institutions which should have lost access to federal student aid because of poor loan repayment outcomes continue to receive taxpayer funding today.

In January 2017, the Consumer Financial Protection Bureau (CFPB) sued student loan servicer Navient for allegedly "steer[ing] borrowers into forbearance" without properly informing them of other options, such as income-based repayment.[13] But phone records for the borrowers CFPB identified as being "harmed by enrollment in forbearance" reveal that most of them did discuss income-based repayment with Navient representatives, yet opted to enroll in forbearance anyway. One borrower, whom CFPB identified as having been "steered" into forbearance by Navient, actually "enrolled in forbearance online without speaking to a representative."[14]

While there are undoubtedly instances where servicers advise borrowers to enroll in forbearance against the borrowers' best interests, the Navient case shows that often the impetus for enrolling in forbearance over alternatives such as income-based repayment comes from the borrower herself. At the margins, better servicing policy can nudge borrowers towards options generally considered better than forbearance (such as income-based repayment), but the scope for improvement is limited so long as borrowers remain legally entitled to request a forbearance, for any reason, for up to three consecutive years.

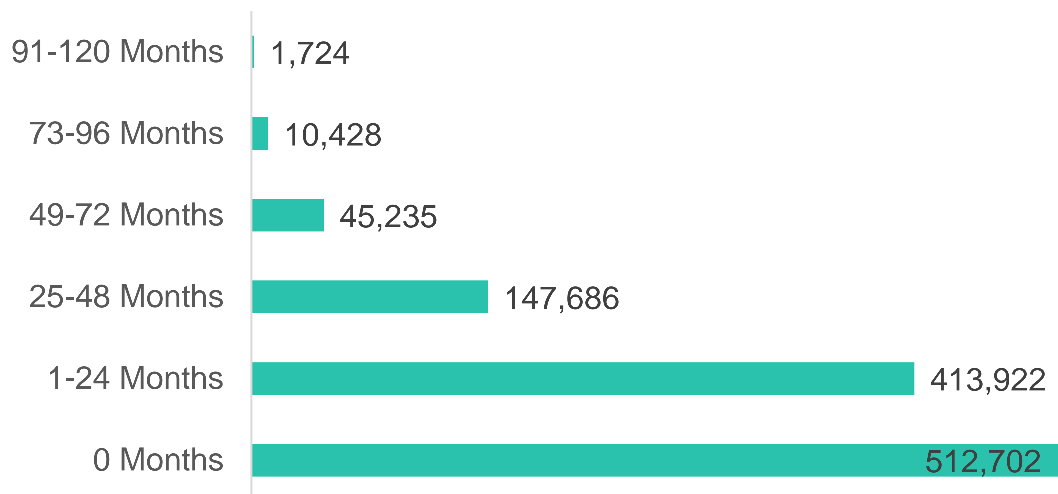
Program Complexity Confuses Public Service Loan Forgiveness Borrowers

Another area where perceived servicer error has led to frustration among borrowers is the Public Service Loan Forgiveness (PSLF) program. In brief, PSLF allows borrowers who work for a designated public service employer to receive full loan forgiveness after making ten years'

worth of qualifying payments. The program was established in October 2007, meaning that the first time a borrower could theoretically qualify for forgiveness was October 2017.[15] PHEAA, also known as FedLoan Servicing, services the loans of borrowers who are working towards PSLF.

As of September 2018, FedLoan had completed processing on 44,724 applications for loan forgiveness under PSLF. Many observers raised questions when it was revealed that only 423 of those applications had been approved. The vast majority (72%) of applications were denied because the borrowers had not met the program requirements, with the remainder denied due to missing information on the application forms.[16]

Figure 2: PSLF Borrowers by Number of Qualifying Payments



Source: Department of Education, Office of Federal Student Aid. The required number of qualifying payments to receive loan forgiveness is 120.

The complicated requirements for PSLF are one reason that many borrowers who believe they should qualify for forgiveness have actually not met the necessary conditions. According to data supplied by the Office of Federal Student Aid (Figure 2), only 1,724 PSLF borrowers have

made 90 or more qualifying payments out of the requisite 120—compared to 41,221 unique borrowers who have submitted an application for forgiveness.[17] Either tens of thousands of borrowers are submitting forgiveness applications by mistake, or they believe they qualify for loan forgiveness when they actually do not.

One reason why this is plausible is that the rules surrounding what constitutes a "qualifying" payment are more complicated than one might think. As of April 2018, FedLoan had certified 891,000 borrowers as working in PSLF-eligible jobs, but over 370,000 of those borrowers had not made a single qualifying payment.[18] Doubtlessly, some of these borrowers have not been making payments at all, but others have been making payments which nevertheless do not count towards PSLF. For instance, only payments made on Direct Loans are qualifying; any payments a borrower makes on federally guaranteed private loans do not qualify unless the borrower consolidates her loans. At the time PSLF was created, about four-fifths of new federal student loans were non-qualifying guaranteed loans.[19] While most (71%) of borrowers working towards PSLF have consolidated their loans, the vast majority of those were making payments before the consolidation occurred, thus extending the amount of time the borrower has to wait before receiving forgiveness.[20]

To qualify for PSLF, a payment must also be made under a qualifying repayment plan, usually an income-driven repayment plan. Twelve percent of Direct Loan borrowers working towards PSLF are in a non-qualifying repayment plan.[21] (In March 2018, Congress passed a temporary measure allowing borrowers in certain non-qualifying repayment plans to nevertheless have their payments count towards PSLF.)[22] Payments made while the borrower is in deferment or forbearance also do not count towards PSLF; 11.5% of Direct Loan borrowers working towards PSLF are in a deferment or forbearance.[23] Finally, if a borrower makes multiple

payments per month, only one payment counts toward the 120 needed to receive PSLF. While this requirement is necessary to ensure a borrower actually works in public-service employment for ten years before receiving forgiveness, it is not always clearly communicated and has the potential to confuse borrowers.

Some of these requirements are critical to the functioning of the program, while others are more superfluous. But they all add complexity and make it more difficult for borrowers to understand what they need to do in order to have their loans forgiven. ED and FedLoan can certainly make more effort to communicate these requirements to borrowers, but sleeker websites and more detailed call-center scripts can only do so much. With program terms so complex, it is no wonder that many borrowers who assume they have met the requirements for PSLF have actually fallen short.

Remedies

There are many changes Congress can consider to improve federal student loan servicing and administration, ranging from incremental to transformational. It should be noted that many of these potential changes are outside the jurisdiction of this committee.

Incremental reforms. While most of the current problems with loan servicing are rooted in the complexity of the student loan program, there are some small changes which can result in an easier experience for borrowers. The Department of Education's NextGen initiative, which aims to provide a single platform for borrowers to manage their loans, has suffered delays but should improve the quality of servicing.[24] Another incremental reform which loan servicer Navient (among others) has argued for is the ability to enroll borrowers in income-based repayment over the phone; currently borrowers must enroll either online or by mail.[25]

Moderate reforms. Congress could simplify the terms of the loan program to reduce the scope for errors, confusion, and suboptimal outcomes. For instance, Congress could curtail excessive use of forbearance by limiting discretionary forbearances to three consecutive months, down from the current limit of three years. Congress could also limit the use of forbearance to specific circumstances, ending the broad discretion servicers currently have to enroll borrowers in forbearance. Reforming PSLF is more difficult, as simplifying the program requirements is likely to increase the number of borrowers receiving forgiveness, and thus cost taxpayers money. But Congress could offset these costs by narrowing the definition of qualifying public service employment or capping the amount that can be forgiven under PSLF. The Obama administration proposed a cap of $57,500, [26] which the Congressional Budget Office estimates would save $6.4 billion over ten years.[27]

Bold reforms. It is possible to obviate the need for loan servicers entirely by collecting student loan payments through the payroll withholding system we currently use for taxes. The United Kingdom and Australia currently use a system like this; Senator Lamar Alexander is expected to introduce legislation that aims to replicate this model in the United States. But this is easier said than done; using the payroll-withholding system to collect student loan payments would likely require a complete overhaul of the federal student loan system. For instance, student loan payments are due monthly, whereas tax liability is calculated yearly. Additionally, income-based repayment plans use a version of *household income* to determine payments, whereas an employer who withholds money from an employee's paycheck would only be able to calculate payments based on the employee's *personal wage and salary income*. Harmonizing federal student loans with the tax system is not impossible, but it is a more difficult task than proponents generally assume.

Conclusion

Since its beginning in 1958, the federal role in student loans has grown ever more expansive and complex. While many of the complicating reforms Congress has undertaken since then might have been desirable in isolation, the cumulative effect of those changes has led to a sprawling program which is very difficult for either the federal government or servicers to administer effectively. To improve servicing, program simplification is key. This concludes my testimony, and I look forward to answering your questions.

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