

Issue Paper 8
Session 1: January 12 – 14, 2016

Issue: Prohibiting Guaranty Agency Interest Capitalization Upon Loan Rehabilitation

Statutory cite: Section 428H(e)(2) of the Higher Education Act of 1965, as amended

Regulatory cite: 34 CFR 682.202(b)(3) and 682.202(b)(4)

Summary of Issue:

Some Guaranty Agencies capitalize unpaid accrued interest after a borrower has rehabilitated a defaulted loan. The Guaranty Agencies claim the authority to do so based on the provision in 34 CFR 682.202(b)(3) that “capitalization is again permitted when repayment is required to begin or resume” or in 34 CFR 682.202(b)(4) that a lender may capitalize interest “when the loan enters repayment”. Some Guaranty Agencies may also view the rehabilitation agreement as an exercise in forbearance of the borrower’s obligation to repay the loan in full (that obligation having been accelerated upon default), and thus consider the rehabilitation agreement to be comparable to a forbearance agreement. Interest is generally capitalized upon the conclusion of a forbearance period. However, the Department of Education (Department) did not intend for the language in 34 CFR 682.202(b)(3) or (b)(4) to be applicable to a borrower who has rehabilitated a defaulted loan.

The language in 682.202(b)(3) specifies the permitted timing and frequency of capitalization that is authorized in 682.202(b)(2). Therefore, the language, “when repayment is required to begin or resume” is a point at which interest capitalizes, but must be read relative to the bases for interest capitalization outlined in 682.202(b)(2). For example, one basis for capitalization is 682.202(b)(2)(iv), which is related to unpaid interest that accrued during a period of deferment. 682.202(b)(3) allows capitalization to occur as frequently as quarterly in this instance, and again when repayment resumes—therefore, when the deferment ends. Loan rehabilitation is not listed as a basis for interest capitalization in 682.202(b)(2).

Regardless of the applicability of the language in 682.202(b)(3) to circumstances outside those enumerated in 682.202(b)(2), it is important to understand that the language “when repayment is required to begin” and “or when the loan enters repayment” was only intended to apply to a loan initially entering repayment, as this is the beginning of the repayment obligation. If it were intended to apply to other circumstances when repayment could arguably “begin” after a loan initially enter repayment, then there would be no necessity for the language “or resume” in 682.202(b)(2). Furthermore, a borrower’s obligation to repay is not generally suspended between the time that a loan is in default and the time that a loan is rehabilitated. Because the borrower was still technically in repayment, a borrower does not “resume” repayment when a defaulted loan is rehabilitated, and a rehabilitation agreement is not the equivalent of a period of forbearance.

Improper interest capitalization potentially increases costs for borrowers and taxpayers and revenues for guaranty agencies and lenders. Moreover, this change would standardize the practice of Guaranty Agencies across the industry, provide more certainty over what practices are permitted, and ensure that all borrowers are treated consistently with regard to interest capitalization upon loan rehabilitation.

The question to be considered by the negotiating committee is:

1. Should the Department amend 34 CFR 682.202 to clarify that Guaranty Agencies may not capitalize interest when a borrower rehabilitates a default loan?