Student Loan Rehabilitation

Options to Resolve Default

Loan rehabilitation is a one-time opportunity to clear the default on a defaulted federal education loan and regain eligibility for federal student aid. If you redefault on the loan, you will not be able to rehabilitate the loan a second time. If a judgment has been obtained on the defaulted loan, it is not eligible for rehabilitation.

Consolidation of Defaulted Loans

After the borrower has made 3 consecutive, voluntary, on-time, full monthly payments on a defaulted loan, the loan may be consolidated. On-time is defined as payments within 15 days of the due date. Effective July 1, 2010, borrowers who are in default may consolidate into the Direct Loan program immediately (without any payments prior to consolidation) if they agree to repay the debt using income-contingent repayment or income-based repayment.

Consolidation is not generally an option for borrowers who have an active dispute of the amount or obligation to repay one of the loans that will be consolidated. A consolidation loan is a new loan that pays off the old loans, and so will be available to the borrower only if the dispute has been resolved.

Regaining Eligibility for Federal Student Aid

After the borrower has made 6 consecutive, voluntary, on-time, full monthly payments on a defaulted loan, the borrower regains eligibility for federal student aid. On-time is defined as payments within 15 days of the due date. The borrower must continue to make these payments in order to retain eligibility for federal student aid.

Rehabilitation and Removal of Default

After the borrower has made 9 out of 10 consecutive, voluntary, on-time, reasonable and affordable monthly payments on a defaulted student loan according to a loan rehabilitation agreement, the loan may be rehabilitated and the default removed from the borrower's credit history. On-time is defined as payments within 20 days of the due date for FFEL and Direct Loan program loans and 15 days for Perkins loans.

Rehabilitation of FFEL program loans usually requires that the loans be sold to a lender after the borrower completes the steps required to rehabilitate the loan. It may take up to 90 days after the loan is sold for the default to be removed from the borrower's credit history. Rehabilitation of Direct Loan program loans is automatic when the borrower has completed the steps required to rehabilitate the loan. But it may still take up to 90 days after the loan is rehabilitated for the default to be removed from the borrower's credit history.

Reasonable and Affordable Payments

The payments must be reasonable and affordable, as determined by the guarantee agency based on the borrower's total financial circumstances. Consideration of total financial circumstances includes a review of the borrower's disposable income (including welfare benefits, Social Security benefits, child support, veterans benefits, SSI and workmen's compensation) and "reasonable and necessary expenses", such as food, housing, utilities, medical care, work-related expenses and dependent care costs. The guarantee agency will want to see documentation of the income and expenses.

Generally, a monthly payment is considered to be reasonable and affordable if it is at least 1.0% of the current loan balance. Collection and guarantee agencies may treat a monthly payment as reasonable and affordable without justification if the loans are consolidated and the monthly payment is at least 1.0% of the balance of the consolidated loan (including any collection charges added to the principal balance). Amounts between 0.5% and 1.0% will need to justified by the borrower's total financial circumstances. If the loans are not consolidated, the collection agencies will seek a monthly payment that is at least 1.29% of the outstanding balance on the loans (1.15% for Perkins loans).

The collection agencies earn their full commission if the monthly payment after consolidation is at least 1.29% for balances under $7,500, 1.14% for balances between $7,500 and $10,000, 1.00% for balances between $10,000 and $20,000, 0.87% for balances between $20,000 and $40,000, and 0.76% for balances over $40,000. So the collection agencies will pressure borrowers more when the monthly payment is below these thresholds. The collection agencies will also pressure borrowers when the monthly payment after consolidation is more than $25 less than the monthly payment under income-contingent repayment.

Payments can be less than the required minimum payment amount ($50 or the interest that accrues) if a smaller amount is determined to be "reasonable and affordable" based on the borrower's total financial circumstances.

Voluntary Payments

Voluntary payments do not include any payments made through wage garnishment or income tax refund offset. Often the collection agency or guarantee agency will ask for a full payment on top of the involuntary payments, but sometimes can be convinced to accept the involuntary payments as part of a voluntary payment, so long as the voluntary "reasonable and affordable" payment is greater than the involuntary payments. The collection agencies will often round up to the nearest multiple of $5 or $10.

On-Time Payments

On-time is defined as either within 15 days of the due date or within 20 days of the due date. The 15-day standard is used for consolidation and regaining federal student aid eligibility, while the 20-day standard is used for loan rehabilitation.

If a payment is even just one penny less than the payment required by the loan rehabilitation agreement, it will count as a missed payment.

Addition of Collection Costs

Rehabilitating a loan will generally involve adding collection costs of up to 18.5% of the unpaid principal balance and accrued interest to the principal balance of the loan. (The 18.5% figure is less than the 25% collection costs — effectively, 20% of each payment — that are currently deducted from a defaulted borrower's payments.)