As described in the prior two subsections, after you default on your federal student loan by missing nine months of payments, you may be subjected to harsh collection tactics and lose access to some of the most generous repayment plans and deferments. It is greatly to your advantage to get out of default. One way is to cancel the loan as described earlier in the chapter. Three other ways are described below, but these do not happen automatically—you must press for your rights and initiate the request.

Reach a Settlement to Pay Off Your Loan Balance. You can get out of default by negotiating a settlement with your loan holder or the Department of Education to pay a lesser amount to pay off the loan. It can be difficult to negotiate a “good” deal, and you probably will need a large, lump-sum amount to offer. Get any settlement in a writing that confirms that you no longer owe anything, then pay on time, and request a satisfaction letter as proof of your payment in case someone attempts to collect further from you. Consult with a tax professional about any tax liability from your settlement.

Loan Consolidation. Loan consolidation is taking out a new federal Direct Loan that repays at least one Perkins, FFEL, or Direct Loan. Your consolidation loan, being new, is not in default. Being a Direct Loan, it is eligible for plans to reduce your payments not available to those with FFEL or Perkins Loans. Consolidation can also simplify repayment if you currently submit payments to multiple servicers.

You can apply online and need not deal with debt collectors or servicers. You can consolidate your loans only once, although there are a few exceptions to this, such as if you are adding new loans that were not included in the first consolidation. Consolidation is not an option if your wages are presently being garnished to repay your student loans. (You can still consolidate if the government is taking part of your Social Security benefits or other income, though.) If you consolidate loans in default, collection costs may be added into the consolidation loan, increasing your loan balance by as much as 18.5%. Since the consolidation is a new loan, you may lose the right to raise defenses you have on the old loans, though there are strong arguments that you can retain those rights.

You must either pay the consolidation loan through enrollment in an income-driven repayment plan (such as PAYE, described above) or by first making three consecutive reasonable and affordable monthly payments. Because you need to do only one or the other, do not believe a collection agency that tells you that you have to make three payments on your old loans before you can consolidate. Consolidation also extends your repayment term and, therefore reduces monthly payments if they are not otherwise reduced through enrollment in a payment plan that takes your income into account.

Distinguish Direct Consolidation Loans from private loan consolidation products. It is dangerous to consolidate federal loans into a private consolidation loan. If you consolidate into a private loan, you lose the rights you have under the federal loan program, including rights to cancel or reduce your loan payments. Private lenders may even offer you bonuses if you agree to consolidate with them, but this may not be the right choice for you. Read the fine print!


Loan Rehabilitation. This section explains how to get out of default by “rehabilitating” your Direct or FFEL Loan—the rules are slightly different for Perkins Loans. Loan rehabilitation requires you make nine payments within twenty days of the due date during a period of ten consecutive months. After five consecutive payments, wage garnishments stop. If needed, call the collection agency or your loan holder to remind them to stop the garnishments. Once you make six consecutive payments, you re-establish eligibility for new federal student loans and grants. You must complete all nine payments, and then a Direct Loan gets out of default. For an FFEL Loan, the loan holder must also sell your defaulted loan to a new lender. If you don’t make all of your payments, you have to start the rehabilitation process all over again.

Rehabilitation payments need not be at your old payment amount, but can be at a “reasonable and affordable” amount. Request lower payments and the collector should offer payments equal to 15% of the difference between your income and 150% of the poverty line. In 2018, 150% of poverty was $1,517/month for a one-person household, $2,057/month for a two-person household, and $3,137/month for a four-person household. (The numbers vary in Hawaii, Alaska, or with different family sizes.) For example, if your monthly income is $120 above 150% of the poverty line, you only pay $18 a month.

If the amount is still too high, try to negotiate a lower amount based on your income and expenses. The minimum monthly payment for rehabilitation is $5—even if your income is below 150% of the poverty line, you still have to pay $5 each month during rehabilitation.

After a successful rehabilitation, you are no longer in default, the default notation is removed from your credit record, and a
new repayment schedule is established, but you are still paying on the same loan. You should have access to all of the flexible and income-driven repayment plans that fit your loan type, and you regain eligibility for deferments and forbearances you have not exhausted. The amount of your rehabilitated loan increases as much as 16% to reflect collection costs. Once you rehabilitate your loan, you will not be able to do it again if you end up back in default.

Pros and Cons of Consolidation vs. Rehabilitation. Weigh the pros and cons between consolidation and rehabilitation; do not be pressured by a debt collector to choose one or the other. Make sure that you can afford to make the new payments for the option you choose so that you don’t end up back in default.

Consolidation gets you out of default as soon as the loan is consolidated; rehabilitation requires nine payments in ten months; and for FFEL loans, there must be a buyer for your loan. Consolidation removes all loans from default with the one consolidation; rehabilitation may require you to separately deal with each loan. If you have an FFEL or Perkins Loan, only consolidation into the Direct Loan program gives you access to some of the newer income-driven repayment plans. Consolidation allows you to apply online; rehabilitation requires you to work out a payment amount with debt collectors. When you consolidate, you choose your new servicer, but you don’t have that option when you rehabilitate a loan.

Rehabilitation’s main benefit is that if you successfully complete the rehabilitation process, the default notation on your credit report is erased, but any other negative information still remains. After consolidation, the credit report notes that you had a defaulted loan for a period of time, but that the loan is paid in full. If you have claims and defenses concerning your federal student loan, you may lose the right to raise them after consolidation (though that is disputed), but not after rehabilitation.

Source: National Consumer Law Center, Surviving Debt [50th NCLC Anniversary Edition], updated at www.nclc.org/library
Source URL: https://library.nclc.org/sd/1306

Links