ACADEMY of ART UNIVERSITY®

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Message to Federal Loan Borrowers

Understanding Capitalization

You might have heard the term "interest capitalization" come up during conversation with a Financial Aid Representative, parent(s), or Federal Loan Servicer. It can be a tricky concept to understand, so let's break it down.

What is interest?
Interest is the cost of borrowing money. Interest begins to accrue when unsubsidized loan funds are disbursed to your student account to help pay your tuition and fees.
Interest will begin to accrue on a subsidized loan debt after your grace period expires.
The amount of interest you pay depends on:

- The amount of money you borrow (principal)
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- The rate at which interest is charged (interest rate)
- Whether or not the government helps pay the interest (interest subsidy)
- The length of time it takes you to repay the loan (loan term)

Where does capitalization come in?
Often, you don't have to make payments on your Federal Student Loan(s) while you're in school (deferred payments) or during your grace period after leaving school (up to 6 months).

Any unpaid interest that accrues during this time is added to your loan principal before your payments are due. This is known as capitalization.

When that interest is capitalized, its added to the amount you borrowed. From that point on, interest accrues on the higher balance. Basically, you end up paying interest on interest.

Does capitalization increase my loan balance?
Yes, but you can also look at it as the cost of being able to postpone your loan payments.

Can I avoid capitalization while in school?
Yes, although not everyone is able to afford it, making interest-only payments before you begin regular loan payments can limit the negative effects of capitalization.

If interest is paid off as it accrues, there's nothing to be capitalized when the time comes to enter into repayment. Most borrowers enter into repayment 6 months after they graduate, drop below half time or cease to attend classes.

Early payments (within 120 days of getting your loan funds) are treated as a refund, which reduces your principal loan amount. That's a great thing for you because it reduces the amount of interest that accrues on your loan as if you'd never borrowed that money to begin with. So, the bottom line is, if you don't need the money, don't borrow it.

Making payments while you are still in school reduces what you owe in the long run. If you can afford it, a great way to hold down costs is to make student loan payments while you are still enrolled in school. Depending on when you make the payment, the loan servicer will apply it in a way that saves you the most money in the loan run.
Here’s how it works:

For the biggest impact, make a payment to your loan servicer within the first 120 days of getting your loan disbursement (the amount of money transferred to your school to pay your tuition) Your payment will be treated like a refund and will reduce the amount of money your borrowed through the Federal Loan program. It will reduce your overall principal balance.
When you do this, it will create a win-win situation. Not only is your principal balance reduced but any balance accruing interest will be recalculated based on the reduced principal balance, so your overall accrued interest is reduced accordingly.

Additionally, a full or prorated portion of any origination fees are credited back to your account reducing your principal balance even further. You can also choose to apply your payments made within 120 days of disbursement as a regular payment if you prefer. This will help you keep up with your accrued interest, so it isn’t capitalized; however you won’t benefit from the reduced principal reduction. Payments made toward your Federal Loans after the 120 days from disbursement will be applied as a regular payment, it will be applied toward interest first and then to your loan principal.