**U.S. House of Representatives Committee on Education and the Workforce**

# "Keeping College Within Reach: Simplifying Federal Student Aid"

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Chairman Kline, Ranking Member Miller, and committee members, thank you for inviting me to testify about the need to simplify the federal student loan program.

From the borrower's perspective, the federal student loan program is unnecessarily complex, and many of its most important benefits are opt-in, difficult to access, or even hidden – and many terms and benefits overlap or cancel one another out. When a student applies for federal loans, he will confront a mix of types, terms, and names. Some may make sense to him, others will confuse him, and some he may not even know exist. Will he know that a **"**Stafford**"** loan is a federal loan? Will he understand that "unsubsidized" doesn't mean he is getting a bad deal?

When a student begins to repay his loans, he will have up to nine different repayment plans from which to choose, each with its own set of terms and eligibility rules. But here is the kicker: The Department of Education, by law, will automatically enroll him in the plan where he will make the *highest* monthly payments and receive the fewest benefits – the 10-year standard repayment plan.

To be sure, this policy signals to borrowers that they should repay their loans quickly. Yet policymakers must recognize the inherent trade-off in that policy: Borrowers who really need to make lower payments (by extending the duration of the loan, in some cases) may not understand that they have such an option or may not be able to successfully navigate the enrollment process.

As Congress considers a reauthorization of the Higher Education Act in the coming months, lawmakers should make it a priority to remedy these issues. Briefly, Congress should minimize the different names, types, and terms of the loans when issued, and then offer just one plan when borrowers repay: a modified version of the existing income-based repayment plan, or what the Obama Administration calls Pay As You Earn.

The program must be modified because, in its current form, Pay As You Earn is a massive tuition assistance program for graduate students that doubles as a means-tested safety-net program.

Likewise, the Public Service Loan Forgiveness benefit under Pay As You Earn is an even larger tuition assistance program for graduate students that allows for excessive amounts of loan forgiveness for high and low earning borrowers alike. Before making Pay As You Earn the only repayment option, as I am recommending, Congress must ensure that its loan forgiveness benefit is truly – and only – a safety net, and that the Public Service Loan Forgiveness benefit is subject to limits.

To help illustrate the complexity and myriad benefits that the federal student loan program provides, below is a list of the relevant loan rules grouped by when the borrower encounters them – at origination and during repayment. The remainder of this testimony focuses on how Congress can simplify and improve the loan program.

**Complicated and Confusing Federal Loan Terms at Origination**

- Federal student loans have multiple names, and even the same loan can have many different names. For example, the U.S. Department of Education can refer to the exact same loan as an: Unsubsidized Stafford Loan; a Federal Unsubsidized Stafford Loan; a Direct Federal Unsubsidized Loan; an Unsubsidized Direct Stafford Loan; and a Direct Unsubsidized Stafford Loan.

- The federal loan program offers two different types of widely available loans to undergraduates: Unsubsidized and Subsidized Stafford loans. The former is issued to anyone, regardless of financial need, and the latter is awarded based partially on financial need and partially on the cost of the institution the student attends.

- The borrowing limits are different for each loan type, and many borrowers receive a mix of both loan types in a given semester. In fact, 82 percent of recent undergraduates who have a Subsidized Stafford loan also have an Unsubsidized Stafford loan.[1]

- Subsidized Stafford loans do not accrue interest while the borrower is in school, including subsequent enrollment in graduate school. Unsubsidized Stafford loans do accrue interest while the borrower is in school. Remember, a borrower may have a mix of each loan type, so some of his loans are accruing interest while he is in school and other are not.

- Annual and aggregate loan limits – how much an undergraduate can borrow in the federal program – are different for “dependent” and “independent” undergraduates, but only for Unsubsidized Stafford loans, not Subsidized.

- Some undergraduates may also borrow federal Perkins loans in addition to Stafford loans. Perkins loans have their own set of borrowing limits, repayment plans, and interest rates separate from Stafford loans. There is no standard eligibility criteria for a

Perkins loan, they are only available at certain schools, and students will not know whether they can get a Perkins loan or how much until they receive a financial aid package from a school. Perkins loans are not repaid through the U.S. Department of Education, but are instead administered by a student's school. Graduate students can also receive Perkins loans.

- Parents of dependent undergraduates may borrow federal Parent PLUS loans without any annual or aggregate limit so long as it doesn't exceed a school's total cost of attendance. Students whose parents opt to apply for PLUS loans but fail the very limited credit check for these loans may borrow Unsubsidized Stafford loans at the independent student limits, which are about $4,000 higher per year.

- Borrowers are assessed an origination fee that is automatically rolled into the loan balance and repaid as part of the principal balance. The borrower does not pay the fee upfront like a true origination fee; it is therefore simply part of the effective interest rate on the loan. The origination fees are significantly different for Stafford and PLUS loans: 1.05 percent and 4.2 percent, respectively.

**Complicated and Confusing Federal Loan Terms at Repayment**

- The automatic repayment plan for a federal student loan is the standard 10-year repayment plan. Under this plan, a borrower makes equal monthly payments in the amount necessary to pay off the entire loan, plus interest, in a 10-year period. Most borrowers are enrolled in this plan. However, the standard plan is just one of many (up to nine) options a student can choose from. Any borrower can request to make payments on a "graduated" plan over 10 years where the payments start lower and increase gradually. For graduated repayment, payments may not be lower than the accruing interest and the highest payment may not be three times larger than the smallest in the schedule.

- Borrowers can request an "extended" repayment plan that allows them to repay the loan in fixed payments over 25 years if they have a balance of more than $30,000. Extending the term reduces the borrower's monthly payment, but increases the interest he will accrue and pay. Under this plan, a borrower may also elect to make "graduated" payments with the extended plan and therefore be enrolled in the "graduated extended" plan.

- Extended repayment is not the only way borrowers can lengthen the term of their loans and reduce their monthly payments. They can also do so through the "consolidation" plan, but the terms are completely different from extended repayment. As the name suggests, this option converts a borrower's multiple loans into one, but by far its largest benefit is that it allows borrowers longer repayment terms based on their loan balances. It allows borrowers with balances of $7,500 to $9,999 to pay over 12 years; borrowers

with $10,000 to $19,999 in loans to pay over 15 years; borrowers with $20,000 to $39,999 in loans to pay over 20 years; borrowers with $40,000 to $59,999 in loans to pay over 25 years; and borrowers with $60,000 or more in loans to pay over 30 years. Borrowers can elect to make fixed monthly payments or graduated payments under any consolidation plan.

- Perkins loans must be repaid separately from other federal loans, unless the borrower opts to repay them through the consolidation plan.

- There are three plans that allow borrowers to make payments based on their income and household size, and all offer loan forgiveness. They are Income-Contingent Repayment, Income-Based Repayment, and Pay As You Earn. Each one has different repayment terms and eligibility rules. Some borrowers may qualify for all three, some only for one, and others qualify for none.

**Direct Loan Portfolio by Repayment Plan**

| Standard | | Standard Graduated | | Extended and Consolidation | | Extended and Consolidation, Graduated | |
|---|---|---|---|---|---|---|---|
| Dollars Outstanding (in billions) | Recipients (in millions) | Dollars Outstanding (in billions) | Recipients (in millions) | Dollars Outstanding (in billions) | Recipients (in millions) | Dollars Outstanding (in billions) | Recipients (in millions) |
| $139.9 | 9.84 | $27.8 | 1.27 | $62.1 | 1.63 | $17.5 | 0.45 |

| Income-Contingent | | Income-Based | | Pay As You Earn (New Plan as of Dec. 2012) | | Other/Unknown | |
|---|---|---|---|---|---|---|---|
| Dollars Outstanding (in billions) | Recipients (in millions) | Dollars Outstanding (in billions) | Recipients (in millions) | Dollars Outstanding (in billions) | Recipients (in millions) | Dollars Outstanding (in billions) | Recipients (in millions) |
| $20.1 | 0.63 | $50.9 | 0.91 | $1.3 | 0.04 | $41.7 | 1.00 |

Source: National Student Loan Data System (NSLDS); New America Foundation

*Includes outstanding principal and interest balances of Direct Loans in Repayment, Deferment, and Forbearance*

- Qualifying borrowers with very low incomes need not make any payments on their student loans if they are enrolled in one of the income-based repayment plans listed above. Separately, borrowers need not make any payments on their loans for a limited time if they are enrolled in any of the other repayment plans and are granted “forbearance.” There are two different types of forbearances and multiple ways to qualify for each.

- During repayment, a Subsidized Stafford loan does not accrue interest if the borrower applies for and is granted a deferment (i.e. postponement of payments) because he is unemployed or experiencing an economic hardship at any point during repayment for up to three years. Borrowers can qualify for the same deferment for Unsubsidized Stafford loans, but those loans accrue interest, though it need not be repaid during deferment. Again, many borrowers have *both* types of loans.

**Recommendations to Simplify the Federal Student Loan Program**

*Set One Loan Limit for All Undergraduates, Irrespective of Their Dependency Status*

Policymakers should simplify the federal loan program by eliminating the distinction between dependent and independent undergraduates and allow both types of students to borrow the same amount of loans. Annual limits for all undergraduates should be $6,000 for a first year student, $7,000 for a second-year student, and $9,000 for a third-, fourth-, or fifth -year student. The aggregate limit for undergraduates should be $40,000.

Note that those limits are higher than dependent undergraduates can currently borrow on their own but less than independent undergraduates can take out. The current loan limits for independent students can lead to excessive amounts of debt. As of now, an independent undergraduate student who borrows the maximum in federal loans would begin repayment with a principal and interest balance of approximately $74,000, an amount that would require $486 monthly payments over 30 years to repay under the currently available repayment plans.

*End the Subsidized Stafford Interest Rate Benefit, and Let Income-Based Repayment Subsidize Repayment*

Since the passage of the Higher Education Amendments of 1992, all undergraduate borrowers have been able to take out federal Stafford loans regardless of income or other need-based tests, at terms that have been generally more favorable than those in the private market.[2] Prior to the enactment of that policy, the federal loan program allowed only financially needy students to borrow.[3] These loans had always included an interest-free benefit under which the loan would not accrue interest while the borrower was in school. However, when policymakers opened up the federal student loan program to borrowers of all income backgrounds in 1992, they maintained the interest-free benefit for borrowers who met a needs analysis test that accounted for the cost of attendance at students' institutions, but did not provide a similar benefit for other borrowers.

That interest-free benefit remains the distinction between the two loan types for undergraduates that still exist in today's program: Subsidized Stafford loans and Unsubsidized Stafford loans, with Subsidized Stafford loans carrying the interest-free benefit. Again, 82 percent of recent undergraduates who have a Subsidized Stafford loan also have an Unsubsidized Stafford loan.

Ending the benefit would remove a confusing and oftentimes misunderstood distinction between the loans and it would result in only one type of federal loan for undergraduates. The entire program could then be called "Stafford Loans," dropping the Unsubsidized and Subsidized prefixes.

While that would result in a reduction in benefits for some borrowers, Congress should keep two facts in mind before opposing the change. First, subsidized Stafford loans do not always provide the lowest-income students with the greatest benefits. Because they are awarded to borrowers in part according to the cost of attendance of their schools, a borrower with a high family income will be eligible for the loans if he attends the most expensive type of institution or has siblings in college at the same time. About 12 percent of borrowers who receive Subsidized Stafford loans come from families earning over $100,000 per year.[4] Second, providing an income-based repayment plan better aligns a borrower's ability to repay with what he actually pays on the loans, whereas Subsidized Stafford loans are provided to borrowers based largely on their family income when they enter school.

*End Grad PLUS, but Increase Stafford Loan Limits for Graduate Students*

Policymakers should end the Grad PLUS loan program. This program allows graduate and professional students to borrow up to the full cost of attendance at an institution of higher education, with no time or aggregate limit. Such a policy, especially when coupled with loan forgiveness and income-based repayment, can discourage prudent pricing on the part of institutions and sensible borrowing by students. However, policymakers should increase the annual limit on Unsubsidized Stafford loans for graduate students from the current $20,500 to $25,500 to modestly replace some of the borrowing ability graduate students will lose when the Grad PLUS loan program is eliminated.

Under this proposal, graduate students would borrow only one type of federal loan with uniform terms and limits. Combined with the recommended changes to undergraduate loans, all federal student loans could then be called "Stafford loans" but with a distinction for graduate and undergraduate terms.

Even with an increase in the Stafford loan limits, ending the Grad PLUS program will cause some

graduate students to turn to the private loan market to partially finance their educations. This would ultimately be beneficial in addressing the high costs of graduate schools. If institutions can no longer rely on PLUS loans to fund their high-tuition programs and if the private market is responsive to the ability of borrowers to repay, then graduate schools may have to set their pricing based, in part, on students' expected earnings. Since those in graduate school already have an undergraduate degree and are preparing for a profession, it is more reasonable to expect that loans above the Stafford limits be based on prospective ability to repay. Underwriters will likely focus most intently on institutional characteristics to determine risk, meaning that programs that poorly prepare students to repay their debts will not find that their students can access much credit in the private market, which should change institutional behavior in terms of quality and pricing.

*Income-Based Repayment Should Be the Only Repayment Plan*

Congress should eliminate all of the different repayment programs and replace them with *one* income-based repayment plan similar to those in place now, but with a few essential changes. Those changes would ensure that the plan does not provide high-income borrowers with loan forgiveness; does not allow graduate students to finance most or all of their educations through loan forgiveness, regardless of price; and does not indemnify or reward schools when they charge more, and students when they borrow more. The current program does not sufficiently guard against those outcomes, as is documented in a number of past publications and a forthcoming research paper.[5] Department of Education data also indicate that students with debt from graduate school are predominantly using the Income-Based Repayment plan given that the average balance in the program is $55,769, significantly above the federal loan limits for undergraduates (reliable information for the Pay As You Earn plan is unavailable).[6]

Here are some illustrations of how Pay As You Earn in its current form does not guard against the outcomes listed above. The examples were generated using the New America Foundation's IBR calculator. Each assumes a household size of one. Note that borrowers can exclude a spouse's income from the IBR and Pay As You Earn calculations; they may, however, *still include the spouse in the household size calculation.*[7] Thus, if the household size were larger, the loan forgiveness figures would be larger due to the increase in the income exemption.

- A borrower has an outstanding federal loan balance of $60,000 with an average interest rate of 6.25 percent from undergraduate and graduate studies. He earns a starting salary of $43,000 (with an AGI of $38,700) and an 8 percent annual salary raise every year. In ten years his salary is therefore $86,000. He works at a 501(c)(3) tax-exempt non-profit organization for those 10 years. After his tenth year of payments, he has $61,185 forgiven, the remaining balance on his federal student loans at that point.

- A borrower has an outstanding federal loan balance of $100,000 with an average interest rate of 6.5 percent from graduate studies. He earns a starting salary of $60,000 (with an AGI of $54,000) and a 6 percent annual salary raise every year. In ten years his salary is therefore $87,000. He works at a 501(c)(3) tax-exempt non-profit organization for those 10 years. After his tenth year of payments, he has $119,000 forgiven, the remaining balance on his federal student loans at that point.

- A borrower has an outstanding federal loan balance of $65,000 with an average interest rate of 5.4 percent from undergraduate and graduate studies. He earns a starting salary of $45,000 (with an AGI of $40,500) and a 3 percent annual salary raise every year. In his tenth year of repayment he receives a promotion and his salary jumps to $90,000. He continues to earn a 3 percent annual raise. He works in the private, for-profit sector for his entire career. After 20 years of payments on his federal student loans, he has the remaining balance,$54,000, forgiven. He is earning a salary of $120,000 at that point.

- A borrower has an outstanding federal loan balance of $120,000 with an average interest rate of 6.0 percent from graduate studies. He earns a starting salary of $70,000 (with an AGI of $59,500) and a 3 percent annual salary raise every year. In his tenth year of repayment he receives a promotion and his salary jumps to $110,000. He continues to earn a 3 percent annual raise. He works in the private, for-profit sector for his entire career. After 20 years of payments on his federal student loans, he would have $128,000 forgiven, the full remaining balance on his loan at that point. He is earning a salary of $148,000 when his loans are forgiven.

There are multiple ways to address the current problems with Pay As You Earn. The following changes below are my recommendations that address the issues highlighted above but ensure that the program still provides an essential safety net for borrowers:

1. Maintain the lowest-available-payment calculation (10 percent of Adjusted Gross Income after the exemption of 150 percent of the federal poverty guidelines) but only for borrowers with AGIs at or below 300 percent of the federal poverty guidelines (about $34,000 for a household size of one). Borrowers with AGIs above 300 percent should pay 15 percent of their AGI after the exemption.

2. Link the loan forgiveness timeframe to the amount borrowed. Maintain the loan forgiveness timeframe of 20 years of payment, but only for borrowers whose loan balances when they entered repayment do not exceed $40,000. Borrowers with higher initial balances would qualify for loan forgiveness after 25 years of repayment.

3. Limit the amount of debt that can be forgiven under Public Service Loan Forgiveness. The program currently provides *unlimited* loan forgiveness to a very broad category of "public service" that captures 25 percent of the U.S. workforce.[8] Then consider accelerating when it is provided so that a borrower with an undergraduate level of debt

could benefit. (Because borrowers must make payments for 10 years to qualify, undergraduates are far less likely to have any debt remaining at that point, while graduate students are far more likely to have debt remaining, and forgiven.) For example, borrowers could receive $5,000 in loan forgiveness after five years of qualifying payments and an additional $5,000 after a subsequent five years, thereby limiting loan forgiveness to $10,000 and providing earlier benefits so that students with only debt from undergraduate studies could benefit. Lawmakers should also define "public service" more narrowly than the current rules so that only certain professions or job categories qualify.

4. Eliminate the maximum payment cap. Borrowers must always pay based on the income formulas, no matter how high their incomes are. The current program bases a borrower's payments on his income until they reach what he would pay if he repaid his initial loan balance according to a 10-year fixed payment plan.

5. Instead of Adjusted Gross Income, the program should base payments off of a broader measure of borrowers' incomes. Adjusted Gross Income allows for generous exclusions which includes retirement savings, fringe benefits, and above-the-line deductions. The program should base payments on all wage and other income before pre-tax benefits and above-the-line deductions.

6. Policymakers should also require borrowers to agree in the promissory note they sign upon borrowing to allow their loan servicers and the U.S. Department of Education to access necessary information from their most recent federal income tax return to calculate payments based on income. This will help make income information automatically available to the Department so that it may calculate borrowers' payments without waiting for information from borrowers as is the case in the current system.

With the proposed changes in place, income-based repayment is then the single best option for repayment. Most importantly, making income-based repayment the only repayment option gives borrowers automatic access to the plan with the most risk protections without requiring that they first know it exists and then complete a complicated enrollment process each year. It is likely to reduce delinquency and defaults for the greatest number of borrowers when compared to any other of the repayment plan, although it is impossible to know by how much given how little we know about what causes borrowers to miss payments. Lastly, IBR significantly changes the effect interest rates have on the loans. Borrowers' monthly payments are not dictated by the interest rate charged on the loan, because payments are based *only* on income. To be sure, the interest rate could change the duration of the loan (i.e. how long a borrower pays), but borrowers with persistently low incomes would be shielded from those effects as the added interest would eventually be forgiven.

*Create an Embedded 10-Year Repayment Option*

While income-based repayment would be the only repayment plan available, borrowers should be told how much they would need to pay each month in order to retire their debt in 10 years—thus mimicking the standard repayment option. This is a simple option to add because federal student loans allow borrowers pay off their loans faster than is required, without penalty.

Under this "embedded option" each month a borrower receives his bill (or when he logs into the servicing website) he can see the amount he needs to pay to stay on a 10-year repayment plan based on when he began repaying. Generally, the payment he must make according to the income based repayment formula would be his "minimum monthly payment." In some cases it could be higher. If a borrower has a higher income, then his income-based payment would be higher than payments under the 10-year plan (because this proposal also eliminated the payment cap that exists now under the Income-Based Repayment program). Thus, higher-income borrowers could be required to pay off their loans faster than a 10-year plan would allow. Borrowers with low initial balances would, as well. Even so, required payments would still be based solely on income.

The embedded option ensures that borrowers do not need to enroll in Income-Based Repayment when they need the assistance, but it also allows borrowers to always pay faster if they want to (thus eliminating any extension of repayment that Income-Based Repayment may incidentally encourage) and gives them a target – the 10-year payment plan – against which to gauge their decisions.

*End Deferment and Forbearances*

Congress should end the deferment and forbearance benefits on federal student loans except for borrowers who are in school or in a few special cases, such as military deployment and certain teacher loan forgiveness programs. Income-Based Repayment already includes an exemption for "non-discretionary" income that is equal to 150 percent of the federal poverty guidelines, adjusted for household size. It is approximately $17,700 for a family of one. Thus, borrowers with low incomes need not make payments or may be required to make very small monthly payments.

**Conclusion**

Student loans are an increasingly necessary way for students to help finance their postsecondary educations. But the current system presents them with too many options and choices, both on the front end when they decide to borrow and especially when they enter repayment. Even worse, the smallest benefits are automatically available to all borrowers while larger benefits with the most protections are available only to those who know about them and have the time and wherewithal to navigate the enrollment processes. The suggestions outlined in this testimony would make the programs more straightforward to students, with clearer benefits that are better targeted.

Respectfully Submitted,

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[1] U.S. Department of Education, National Center for Education Statistics. *2011-12 National Postsecondary Student Aid Study*. Computation Sept. 26, 2013 by NCES PowerStats using variables STAFSUB and STAFUNSB.

[2] P.L. 102-325.

[3] Cervantes, A.; Creusere M.; McMillion, R.; McQueen, C.; Short, M.; Steiner, M.; Webster, J. (November 2005). *Opening the Doors to Higher Education: Perspectives on the Higher Education Act 40 Years Later*, TG Research and Analytical Services: http://www.tgslc.org/pdf/hea_history.pdf.

[4] U.S. Department of Education. (March 31, 2011). *FY 2012 Justifications of Appropriations Estimates to Congress: Student Loans Overview.* Available: http://www2.ed.gov/about/overview/budget/budget12/justifications/s-loansoverview.pdf, S-15.

[5] Delisle, J. & Holt, A. (2012). *Safety Net or Windfall: Examining Changes to Income Based Repayment*. Washington, D.C.: New America Foundation. http://newamerica.net/publications/policy/safety_net_or_windfall; Matthews, Dylan, "How Georgetown Law Gets Uncle Sam to Pay Its Students' Bills," Wonkblog, *The Washington Post* (August 9, 2013) http://www.washingtonpost.com/blogs/wonkblog/wp/2013/08/09/how-georgetown-law-gets-uncle-sam-to-pay-its-students-bills/; Forthcoming paper by Jason Delisle and Alex Holt to be published by Upjohn Press (2014).

[6] U.S. Department of Education, office of Federal Student Aid. *Federal Student Loan Program, Direct Loan Portfolio By Repayment Plan*: *http://studentaid.ed.gov/about/data-center/student/portfolio*

[7] The calculator is in Excel spreadsheet format and can be downloaded at the following address: http://edmoney.newamerica.net/sites/newamerica.net/files/articles/NAF%20IBR%20Calculator%20with%20PSLF%20for%20New%20IBR.xlsx

[8] Consumer Financial Protection Bureau. (2013). *Public Service & Student Debt. Analysis of Existing Benefits and Options for Public Service Organizations:* http://files.consumerfinance.gov/f/201308_cfpb_public-service-and-student-debt.pdf.