ISSUE BRIEF:

The Winding Road of Income-Driven Repayment: *Challenges and Opportunities for Reform*

AccessLex INSTITUTE®

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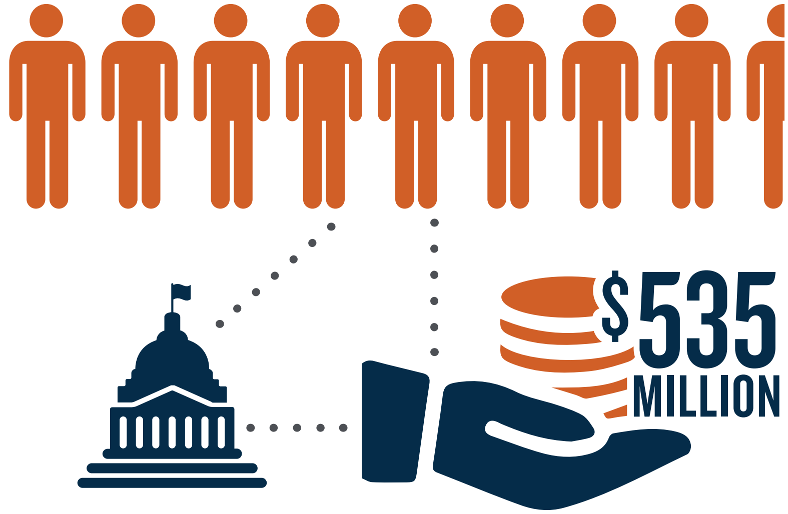
The Winding Road of Income-Driven Repayment

Federal income-driven repayment (IDR) plans, which tie a borrower's monthly payment amount to their income and forgive the balance of the debt after a set number of years, were created to help low-income borrowers better manage repayment and avoid default. Rather than a fixed or graduated repayment plan paid off over a decade, borrowers can choose from one of five different IDR plans that are based on their annual income and family size and repay the loan over 20 to 25 years, depending on the plan and whether the borrower attended graduate school. Each plan is briefly detailed below.



There are about eight and a half million borrowers, holding a combined $535 million in federal loans, currently enrolled in an IDR plan.[1] The use of IDR plans has increased over time, especially during the last decade. Between 2010 and 2017, the popularity of IDR plans grew significantly: the proportion of borrowers in IDR plans went from about 10 percent to 25 percent for undergraduate borrowers and from five percent to 40 percent for graduate borrowers.[2]

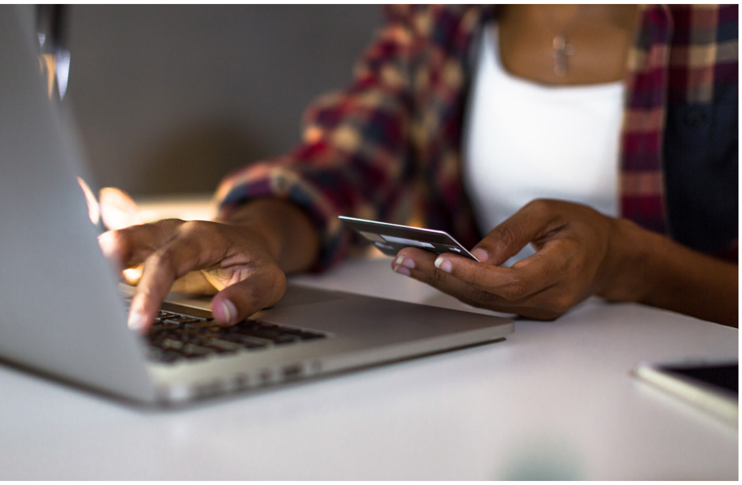
Income-Driven Repayment Plans

The first IDR plan — **Income-Contingent Repayment (ICR)** — was implemented in 1994, but it was only utilized by a small portion of student borrowers, even a decade after the plan's introduction. This is due largely to the fact that it was not available to certain students, and for borrowers without poverty-level incomes it rarely offered lower monthly payments.[3] The ICR plan allows Direct Loan borrowers to make monthly payments that are the lesser of 20 percent of discretionary income or a 12-year fixed payment (adjusted according to income). The loan is discharged after 25 years and does not require the borrower to demonstrate partial financial hardship (PFH).[4]

Over the years, both Congress and the Obama Administration took action to make several more plans available that build on the ICR plan, increasing flexibility and accessibility for borrowers.[5]

In 2009, Congress expanded IDR with the availability of the **Income-Based Repayment (Old IBR)** plan. The IBR plan requires monthly payments that are 15 percent of discretionary income and can never be more that the ten-year Standard repayment amount. All debt is canceled after 25 years of repayment, and it requires the borrower to demonstrate proof of PFH.

The **Pay As You Earn (PAYE)** plan rolled out in 2012 and is available to any new borrower as of October 1, 2007, and for Direct Loan disbursements on or after October 1, 2011. It requires debtors to make monthly payments that are 10 percent of discretionary income, forgives debt after 20 years, and requires the borrower to demonstrate proof of PFH.



A second **IBR plan (New IBR)** was unveiled in 2014 and can be used by new borrowers as of July 1, 2014, so long as they have no outstanding balance on any prior Direct or Family Federal Education Loan (FFEL) Program loan. Student borrowers must make monthly payments equal to 10 percent of discretionary income and show proof of PFH. The loan is discharged after 20 years of qualifying payments.

Most recently, the **Revised Pay As You Earn (REPAYE)** plan was made available to all Direct Loan borrowers in 2015. This plan sets monthly payments at 10 percent of discretionary income, has no cap on the monthly payment amount, and does not mandate proof of PFH. Debt is forgiven after 20 years for undergraduate borrowers and 25 years for graduate borrowers.

PLAN	LOAN TYPE	PFH	MONTHLY PAYMENT	DEBT CANCELLED AFTER
Income Contingent (ICR)	Direct Loans (Consolidation loans that are repaid via Parent PLUS are eligible)	No	The lesser of **20%** of discretionary income or a 12-year fixed payment, adjusted according to income	25 years
Income Based (Old IBR)	Direct and FFEL Loans	Yes	**15%** of discretionary income and never more than the 10-year Standard Repayment amount	25 years
Pay As You Earn (PAYE)	Direct Loans for new borrowers as of 10/1/2007 and Direct Loan disbursement on or after 10/1/2011	Yes	**10%** of discretionary income and never more than the 10-year Standard Repayment amount	20 years
New Income Based (New IBR)	Direct Loans for new borrowers as of 7/1/2014, so long as they have no outstanding balance on any prior Direct or FFEL loan	Yes	**10%** of discretionary income and never more than the 10-year Standard Repayment amount	20 years
Revised Pay As You Earn (REPAYE)	Direct Loans	No	**10%** of discretionary income and no cap on the monthly payment amount	20 years for undergraduate and 25 years for graduate

Challenges

While IDR plans are well-intentioned and meant to help struggling borrowers manage repayment, the general consensus among nearly all stakeholders is that IDR has, unfortunately, over time, evolved into a web of cryptic and opaque options that leave too many student borrowers behind. There are several challenges borrowers face when they decide to enroll in an IDR plan, some of which can actually make it harder for them to repay their loans.

Complexity can cause confusion and harmful outcomes for borrowers. The availability of five different plans, each with slightly different terms, can be confusing for borrowers and make it hard for them to know which plan is best for them. Borrowers without strong financial literacy or clear guidance can be overwhelmed by — or just as likely be unaware of — the criteria and ramifications of the multiple IDR options available to them. As a result, some borrowers select a repayment plan that is not the best fit, which in turn means the program does not provide them with the relief they need and that was intended by the program.

Loan balances can grow after entering repayment. There are some plans that are structured in such a way that, because of low payments paid out over a long period, actually cause a borrower's loan balance to increase during the repayment period. It is counterintuitive: a borrower could be making monthly payments for years but still owe about the same or even more than they did when they graduated. For example, if the borrower's monthly payment does not fully cover the interest on the loan — also known as *negative amortization* — a borrower's debt load will increase rather than decrease. Additionally, if a borrower leaves a certain plan or exits a deferment or forbearance, it can trigger *interest capitalization*. This means that all accumulated unpaid interest gets added to a borrower's principal loan balance. When interest capitalizes, a borrower can end up paying more over a longer period or have larger amounts forgiven at the end of their repayment plan. Seeing the balance of a loan increase while making full payments each month can create a psychological burden on borrowers and add to a sense of hopelessness of ever paying off their student loan debt. It is also counterproductive to allow balances that will ultimately be forgiven to increase.

Debt cancellation will mean a heavy tax hit again soon. Student borrowers will receive debt cancellation on any remaining loan balance after the completion of their plan's repayment schedule. The *American Rescue Plan Act* makes federal student loan forgiveness tax-free until 2025, but after that, any forgiveness under IDR plans will incur a tax liability. If no additional action is taken after 2025, borrowers in IDR will once again be in the position where, after decades of repayment, they may be on the hook for a hefty tax bill they cannot afford shortly after they receive debt cancellation.

The annual recertification of income process is cumbersome and can lead to higher payments. For a borrower to remain enrolled in an IDR plan, they currently must recertify their household income by submitting a form and income documentation to their loan servicer each year. This is required to make sure their monthly payments are correctly calibrated to their earnings. If the borrower does not successfully complete this process, they can be removed from the IDR plan and placed into the Standard ten-year repayment plan, which often results in higher payments. For some borrowers, the burden of higher monthly payments can lead to forbearance or default.

Graduate students are penalized in the REPAYE plan. Under the REPAYE plan, undergraduate students receive debt forgiveness after they make qualifying payments for 20 years. However, graduate students must make an additional five years of qualifying payments before they are eligible for debt cancellation. Today's job market increasingly requires a graduate degree for jobs that previously did not, thus pushing applicants to obtain a graduate degree to remain competitive in certain fields. Penalizing graduate borrowers also creates an equity issue: 79 percent of Black students rely on financial aid for graduate school compared to 56 percent of White students.[6] Black students must also earn a credential beyond a bachelor's degree to receive pay similar to their White peers who only hold a bachelor's degree. Currently, Black bachelor's degree-holders make 20 percent less than White bachelor's degree-holders.[7] Adding five years to the repayment term of graduate borrowers in IDR plans penalizes borrowers for structural issues outside of their control and cuts against the government's stated role in higher education: improving access

Recommendations

The challenges outlined above require substantive and meaningful changes that will make IDR plans work better for borrowers and go a long way in making repayment truly manageable. Policymakers and other stakeholders have several opportunities to make the changes proposed below, including through negotiated rulemaking and the reauthorization of the Higher Education Act. With the number of borrowers relying on IDR to manage their repayment continuing to grow, policymakers must not delay.

In addition to the changes suggested below, AccessLex Institute recommends (1) keeping the 10-year standard, graduated and extended plans for all borrowers, (2) keeping the five current IDR plans for existing eligible borrowers, and (3) making the new IDR plan available to all existing Direct Loan borrowers who wish to enroll and the *only* income-driven option for new borrowers.

The percentage of discretionary income paid should be based on the level of a borrower's income. A borrower's monthly payment should increase as their income rises, similar to the federal income tax structure. For example, a borrower could pay 10 percent on the first $100,000 of income, 12.5 percent on the next $50,000, and 15 percent thereafter. Basing the percentage of discretionary income paid (defined as income over 150 percent of the poverty line) each month on a sliding scale will ensure that higher income borrowers, who may still need to be in an IDR plan due to high levels of debt, pay more each month. These borrowers are likely in a better financial position to pay a little bit more of their discretionary income. This approach could also result in the federal government collecting more through this new IDR program than it does in the current REPAYE plan which requires all enrolled borrowers, regardless of income, to pay 10 percent of their discretionary income.

Interest capitalization should be eliminated. According to the Congressional Budget Office, graduate and undergraduate borrowers in IDR plans will repay 82.5 percent and 84 percent of the original loan disbursement, respectively.[8] This means that the amount that will be forgiven, in many cases, is mostly accumulated interest. Since this interest will ultimately be forgiven after 20 to 25 years, it would benefit the borrower today for that interest to not capitalize in a way that makes repayment seem futile.

Borrowers should receive forgiveness after 20 years in repayment, regardless of whether they borrowed for an undergraduate or graduate degree. Simply by virtue of having one dollar of graduate education loans, borrowers in REPAYE are saddled with an additional five years of repayment in order to get forgiveness. This disparate treatment of graduate and professional students should not be replicated.

The balance that is forgiven at the end of the repayment period should remain tax-free. The *American Rescue Plan Act's* temporary tax-free treatment of debt cancellation should be made permanent. Borrowers that utilize IDR plans and do not pay off their loan balances are the least likely to be able to afford a high tax bill.

ED should ensure that the automatic recertification of income is not delayed. The *Fostering Undergraduate Talent by Unlocking Resources for Education (FUTURE) Act* allows for data sharing between ED and the Internal Revenue Service (IRS) to determine a borrower's repayment obligation while enrolled in an IDR plan. ED has not specified a date on which this data sharing for IDR purposes will begin, but they have said that data sharing between ED and IRS when a student fills out the Free Application for Federal Student Aid will not begin until 2024, a year later than Congress mandated, in order to update its technology system to support those changes. Because data has shown that a large number of borrowers in IDR plans often fail to recertify on time (sometimes leading to a hardship-related forbearance or deferment), it is imperative that automatic recertification is not delayed to ensure that borrowers remain in IDR plans and avoid payment increases they cannot afford.

There should be no partial financial hardship requirement. Currently, partial financial hardship is an eligibility requirement that must be met to qualify for certain IDR plans. But it leaves borrowers who would otherwise benefit from the program with limited options. Instead, any eligible borrower with a qualifying loan should be able to enroll in IDR, even if it means their monthly payment is higher than under the 10-year Standard plan. This is how the current REPAYE plan is structured.

Joint spousal income should be used to determine monthly payments, regardless of tax filing status. One distinct difference between REPAYE and the other IDR plans is that if a married borrower files their taxes separately, both the borrower's and their spouse's income is used to calculate the monthly payment amount. This change was made to ensure that married borrowers filling separately would not be able to qualify for lower payments than their household income would necessitate. This requirement should continue so that similarly situated borrowers are treated fairly across the board.

1 Federal Student Loan Portfolio. (2021). *Office of Federal Student Aid.* Retrieved from https://studentaid.gov/data-center/student/portfolio

2 Karamcheva, N., Perry, J., & Yannelis, C. (2020). Income-Driven Repayment Plans for Student Loans: Budgetary Costs and Policy Options. *Congressional Budget Office.* https://www.cbo.gov/system/files/2020-02/55968-CBO-IDRP.pdf

3 Delisle, J.D. & Cooper, P. (2021). Fixing income-driven repayment for federal student loans. *American Enterprise Institute.* www.aei.org/research-products/report/fixing-income-driven-repayment-for-federal-student-loans

4 Partial Financial Hardship. (2021). *Office of Federal Student Aid.* Retrieved from https://studentaid.gov/help-center/answers/article/partial-financial-hardship. ("Partial financial hardship is an eligibility requirement under the Income-Based Repayment (IBR) and Pay As You Earn Repayment (PAYE) plans. It is a circumstance in which the annual amount due on your eligible loans, as calculated under a 10-year Standard Repayment Plan, exceeds 15 percent (for IBR) or 10 percent (for Pay As You Earn) of the difference between your adjusted gross income (AGI) and 150 percent of the poverty line for your family size in the state where you live").

5 Delisle, J.D. & Cooper, P. (2021). Fixing income-driven repayment for federal student loans. *American Enterprise Institute.* www.aei.org/research-products/report/fixing-income-driven-repayment-for-federal-student-loans

6 Miller, B. (2020). Graduate School Debt: Ideas for Reducing the $37 Billion in Annual Student Loans That No One Is Talking About. *Center for American Progress.* https://cdn.americanprogress.org/content/uploads/2020/01/10090256/CollegeAffordabilityGap-report5.pdf

7 Carnevale, A.P., Rose, S.J., & Cheah, B. (2011). The College Payoff: Education, Occupations, Lifetime Earnings. *Georgetown University Center on Education and the Workforce.* https://1gyhoq479ufd3yna29x7ubjn-wpengine.netdna-ssl.com/wp-content/uploads/collegepayoff-completed.pdf

8 Karamcheva, N., Perry, J., & Yannelis, C. (2020). Income-Driven Repayment Plans for Student Loans: Budgetary Costs and Policy Options. *Congressional Budget Office.* https://www.cbo.gov/system/files/2020-02/55968-CBO-IDRP.pdf

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