

TO: Interested Parties
FROM: The Institute for College Access & Success (TICAS)
DATE: March 30, 2015
RE: Analysis of aspects of the Education Department’s draft REPAYE plan

In advance of this week’s negotiated rulemaking session, this memo analyzes aspects of the Department of Education’s draft regulatory language establishing a new income-driven repayment plan, called the Revised Pay As You Earn (REPAYE) plan. The draft plan reflects several recommendations from our October 2014 [public comments](#)¹ and February 2015 [memo](#)² to expand access to an improved income-driven plan. Although the Department’s draft proposal does not eliminate interest capitalization as we and others recommended, it does reduce the amount of interest that can accrue when borrowers’ income-driven payments do not fully cover their accruing interest, which our analysis shows would have an even larger positive effect, and for more borrowers, than eliminating interest capitalization alone.

However, the Department’s draft proposal would also add unnecessary complexity, increase costs for some responsible, low- and middle-income student loan borrowers, have unintended consequences, and treat some similarly situated borrowers very differently from each other. This memo analyzes several of these concerns and suggests ways to address them. It also recommends how borrowers who do not submit their annual income documentation on time should be treated, given the proposed removal of the standard payment cap.

If you have any questions about this memo, please contact Pauline Abernathy, Diane Cheng, or Jessica Thompson at (510) 318-7900.

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¹ TICAS’ October 2014 public comments on topics for negotiated rulemaking are available at http://www.ticas.org/pub_view.php?id=956.

² TICAS’ February 2015 memo on Pay As You Earn (PAYE) recommendations for negotiated rulemaking is available at http://www.ticas.org/pub_view.php?id=975.

Maximum repayment period

In the current Pay As You Earn (PAYE) plan, any debt remaining after 20 years of qualifying payments is discharged, though many borrowers will repay their loans in full before the 20-year period is over. We recommend retaining this 20-year maximum repayment period for all borrowers. As detailed in our February memo, research has shown that carrying outstanding student debt may affect borrowers' ability and willingness to make other financial commitments, such as buying a home or a car, enrolling in graduate school, opening a small business, saving for their children's education, or saving for their own retirement.³ For example, one recent survey found that nearly one-third of parents with student debt say that paying their debt has prevented them from saving for their children's higher education (31%) or their own retirement (32%).⁴ Capping loan repayment periods at 20 years would help borrowers focus on saving for retirement and their children's education before the next generation is in college.

Concerns with proposed 25-year repayment period for borrowers owing more than \$57,500

The Department's proposal to extend the REPAYE repayment period to 25 years for borrowers with debt above \$57,500:

- Makes the plan more complex, rather than simpler;
- Increases costs for responsible, low- and middle-income borrowers with over \$57,500 in debt;
- Creates abrupt "cliffs" where borrowers in very similar financial situations get very different benefits;
- Treats students who borrowed the *identical* amount very differently because the repayment length is based on the outstanding balance when entering the plan, rather than the principal amount borrowed; and
- Will, over time, apply to an increasing share of borrowers because the proposed \$57,500 threshold is fixed.

Increases costs for responsible low- and middle-income borrowers based on their debt amount, not their ability to pay

The Department's proposal extends the repayment period based solely on the borrower's debt, not the borrower's income or ability to pay. As a result, it significantly increases repayment costs for responsible borrowers with low or middle incomes if they entered repayment with more than \$57,500 of debt. As illustrated by the example below, the additional five years of repayment could increase costs by *more than 40%* for a borrower with an adjusted gross income of \$45,000.

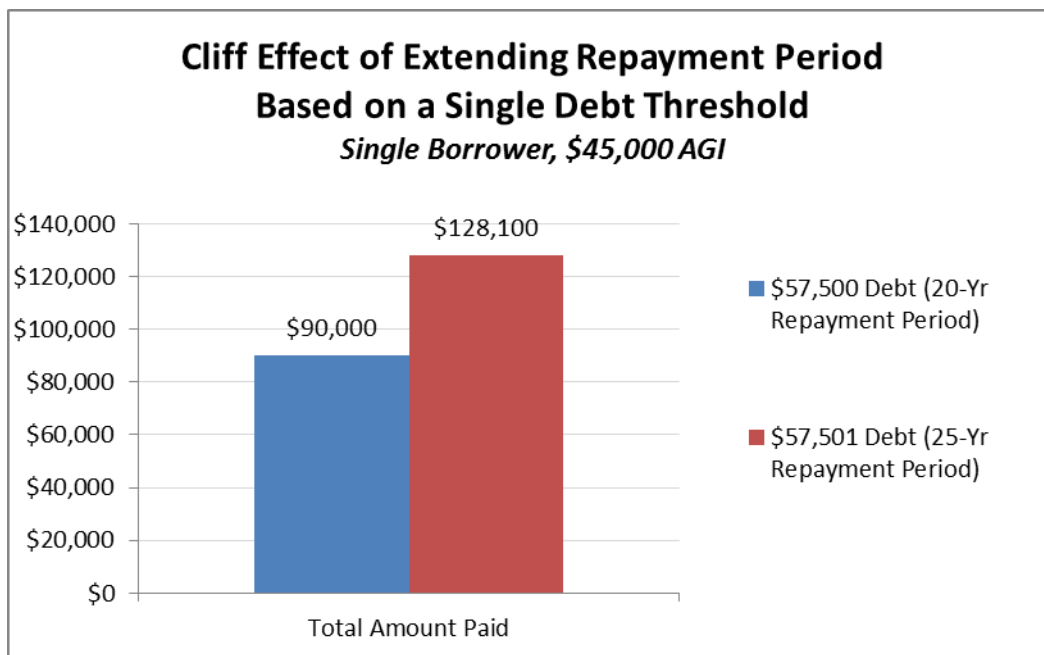
Creates inequitable cliff effects that treat similar borrowers very differently

Using a single debt threshold to determine the repayment period can have particularly harsh consequences for borrowers near the specified threshold, because those with debt \$1 above the threshold can be subject to a substantially longer repayment period than those with debt just \$1 below the threshold. Consider the cliff effect for a single borrower who earns \$45,000 in adjusted gross income

³ Consumer Financial Protection Bureau (CFPB). 2013. *Student Loan Affordability: Analysis of Public Input on Impact and Solutions*. http://files.consumerfinance.gov/f/201305_cfpb_rfi-report_student-loans.pdf. Federal Reserve Bank of New York. April 17, 2013. "Young Student Loan Borrowers Retreat from Housing and Auto Markets." <http://bit.ly/1izd1Jw>. Kim, Dongbin and Therese S. Eyerann. 2006. "Undergraduate Borrowing and Its Effects on Plans to Attend Graduate School Prior to and After the 1992 Higher Education Act Amendments," *Journal of Student Financial Aid* 36(2): Article 1. <http://publications.nasfaa.org/jsfa/vol36/iss2/1>.

⁴ Certified Financial Planner Board of Standards, Inc. September 17, 2014. Press Release. "American Parents Struggle to Save for Higher Education, Manage Living Expenses." <http://bit.ly/1sJti5A>.

(AGI), and whose income increases 4% a year. Under the Department’s proposal, if she has \$57,500 in federal student loan debt, she will pay \$90,000 after 20 years—her entire loan principal plus \$32,500 in interest. However, *if she owes one dollar more*, she will pay \$128,100 in total--\$38,100 or 42% more.⁵ If the repayment period is lengthened based on the borrower’s debt, to prevent this abrupt cliff effect it should be done gradually, rather than increasing the maximum repayment period by five years based on a \$1 increase in debt.



Unintentionally treats students who borrowed the identical amount very differently

The Department’s proposal extends the repayment period to 25 years based on the amount owed when the borrower enters REPAYE, not on the principal amount borrowed. As a result, if two students in a program borrow the same amount, but one goes part-time and takes longer to complete, the one who attended part-time could have to pay much more than the full-time student due to the additional interest that accrued on his unsubsidized loans while he was in school. To prevent this disparate treatment, *if* the maximum repayment period is extended for borrowers with high debt it should be based on the *principal amount borrowed*, not on the amount owed when the borrower enters the plan.

It is relatively easy for borrowers to track how much loan principal they are taking on as they borrow, but it can be difficult to track or limit how much they end up owing. The amount owed when borrowers enter repayment is affected by many factors, including the interest rates on their loans, the type of loans they borrowed and when interest begins to accrue for each loan, how long the student is enrolled at least half-time, and even potentially the length of their program.

For example, under current interest rate projections, an independent undergraduate who borrowed \$52,400 over five years would have a \$57,500 balance when entering repayment.⁶ If undergraduate

⁵ These figures solely illustrate the effect of extending the repayment period to 25 years for borrowers entering repayment with over \$57,500 in debt.

⁶ Calculations assume that the student starts school in 2015-16, graduates in five years, and takes out the annual maximum in subsidized loans and unsubsidized Stafford loans until his last year of borrowing when he borrows less than the maximum. Current interest rate projections are calculated using the Congressional Budget Office’s (CBO)

Stafford loan interest rates hit the statutory cap of 8.25%, this same student would only need to borrow \$49,900 over five years to have a \$57,500 balance when entering repayment.

Will, over time, apply to an increasing share of borrowers

The Department’s proposed \$57,500 threshold is fixed, instead of explicitly tied to loan limits or to inflation. This means that as college costs rise and students borrow more to cover them, an increasing share of borrowers will likely hit the \$57,500 threshold. Additionally, if Congress raises loan limits, more students will likely exceed the \$57,500 threshold. *If* the maximum repayment period is extended for borrowers with high debt, the threshold or thresholds should be tied either to the maximum amount undergraduates may borrow in Stafford loans, as the Repay Act of 2015 (S. 85) would do, or to inflation.

Treatment of borrowers who do not submit income documentation on time

The Department’s draft proposal leaves open for discussion how borrowers who do not submit their annual income documentation on time should be treated in the absence of the standard payment cap. Currently in PAYE, borrowers who do not update their income documentation on time are required to pay what they would have had to pay if they had entered a fixed 10-year repayment plan (often referred to as the “standard” plan) when they entered PAYE, which will always be higher than their prior income-driven payment amount. However, once this standard payment cap is removed, the 10-year standard amount may be *lower* than the income-driven payment amount.

To avoid rewarding borrowers who fail to submit updated income documentation, borrowers who do not submit their annual income documentation on time should be required to pay the *greater of* the 10-year standard amount or their previous income-driven payment amount (based on the last set of income documentation they provided). As noted in the section below, unpaid interest should not be capitalized if borrowers are late in updating their income documentation.

Additionally, we support legislative changes to prevent any payments made without income documentation from counting toward forgiveness. Borrowers who do not update their income information should not have their monthly payments count toward forgiveness until they provide the required income documentation and resume making income-driven payments. This legislative change is needed because, once the standard payment cap is eliminated, borrowers who fail to submit updated income information may end up paying less than if they had documented their income as required. Therefore, allowing payments made in the absence of income documentation to count toward forgiveness could lead to some borrowers receiving forgiveness under REPAYE or Public Service Loan Forgiveness (PSLF) sooner than they should. Counting only those payments made *with* income documentation toward forgiveness requires statutory changes to 20 USC 1087e(e) and 20 USC 1087e(m).

Interest accrual and capitalization

Under current PAYE and the proposed language for REPAYE, interest capitalizes when the borrower no longer has a partial financial hardship (PFH), fails to submit their income documentation on time, and

January 2015 projections for 10-year Treasury Note yields, <http://1.usa.gov/1vdRSyu>. Figures are rounded to the nearest \$50.

when he or she chooses to exit to enroll in another repayment plan.⁷ TICAS and others recommend eliminating the capitalization of interest in income-driven repayment plans because it increases costs for borrowers whose incomes are low for extended periods of time and for borrowers who do not submit income documentation on time. It also inflates the size of any discharged amount at the end of the repayment period. Removing interest capitalization for borrowers in income-driven repayment would slow the growth of these borrowers' loan balances and simplify implementation of the program. Additionally, once the standard payment cap is removed, it is no longer relevant whether a borrower maintains a PFH, and there is no reason for interest to capitalize at that point.

Although the Department's proposal does not eliminate interest capitalization, it does change the treatment of interest accrual for borrowers whose monthly payments do not cover interest (negative amortization). As in PAYE currently, while borrowers are in negative amortization, no unpaid interest accrues on *subsidized* loans during the first three years a borrower is in the plan. In addition, under the Department's proposal, only 50% of any unpaid interest would accrue on *subsidized* loans after the first three years, and only 50% of any unpaid interest on *unsubsidized* loans would accrue at any time borrowers are in negative amortization.

This change in the treatment of unpaid interest would help *minimize the growth of loan balances for borrowers with low incomes relative to their debt*. As a result, these borrowers may pay off their loans faster, pay less in total, and/or have a smaller loan amount discharged at the end of the repayment period than if this interest subsidy were not implemented.

Eliminating interest capitalization helps borrowers who lose their PFH while the Department's proposal would help negatively amortizing borrowers regardless of whether they lose their PFH. In fact, for borrowers who lose their PFH, the Department's proposal to limit interest accrual would have a larger impact on slowing the growth of their balance than removing interest capitalization alone.

For example, consider a borrower with \$25,000 in unsubsidized Stafford loan debt who earns \$15,000 during the first four years of repayment and then finds a job paying \$60,000.⁸ Under both PAYE and the proposed REPAYE, this borrower would repay in full and have no debt discharged. However, in PAYE, interest would capitalize after she gets the better paying job because she would no longer have a PFH. Eliminating the capitalization of interest would reduce her total costs by \$1,200 and reduce her time in repayment by four months. By contrast, the Department's proposal to limit interest accrual would reduce her total costs by \$7,400 and reduce her time in repayment by more than two years.

TICAS supports the proposed treatment of accrued interest in REPAYE as well as the elimination of interest capitalization. Together, these complementary changes slow the growth in the amount owed for borrowers unable to cover interest payments. The elimination of interest capitalization removes a financial penalty for borrowers who lose their PFH, which is no longer a relevant marker if the standard payment cap is eliminated, and for borrowers who do not submit their annual income documentation on time.

⁷ Borrowers no longer have a PFH when 10% of their discretionary income becomes greater than or equal to the 10-year "standard" payment amount due to changes in their income and/or family size, or when borrowers fail to submit their annual income documentation on time.

⁸ The income amounts are adjusted gross income (AGI). The borrower's income increases 4% each year during the first four years and after this borrower gets the better paying job in year five. For simplicity, these examples compare the effect of isolated changes to the treatment of interest for negatively amortizing loans in PAYE, rather than looking at combined changes in REPAYE.

The “partial financial hardship” (PFH) requirement for enrollment

The Department’s draft proposal retains in REPAYE the requirement from PAYE that borrowers must have a PFH when they enroll in the plan, even though borrowers do not need to have a PFH to stay enrolled in either plan. We continue to recommend that all Direct Loan borrowers be permitted to enroll *regardless of their debt-to-income level*. Borrowers who want the assurance of having their loan payments fluctuate with their income could then enroll whenever it makes sense for them, whether it is before they make their first payment, after they have hit a rough patch, or when they are concerned about what the future will bring. This change would greatly simplify the repayment plan, not only for borrowers but also for program administration and communication, *without* increasing the chance of forgiveness for higher income borrowers. Additional details supporting this change can be found on page 9 and in Appendix B of our [February memo](#).