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Flaws in the Design of the Income Contingent Repayment Plan

By Mark R. Cannon

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With the increasing reliance on loans to finance higher education, graduates today are beginning their post-college careers with a greater level of indebtedness. As a result, an array of flexible repayment options has sprung up to help today's student borrowers better manage their debt burdens. The repayment options can be confusing; thus, increasing emphasis is being placed on borrower counseling to assure that students have all the information they need to select the best repayment option for their personal financial circumstances.

Among the least understood payback mechanisms is Income Contingent Repayment (ICR) now available under the Federal Direct Loan Program. While income-based repayment options in general are viewed as helping ease the burden for the student borrower with high debt and modest income-earning prospects, the specific repayment path established by the Department of Education for ICR "can be very costly down the road."¹

A close examination of ICR's current repayment rules strongly suggests that, for many borrowers, this plan will prove considerably more expensive than other repayment options in terms of total interest costs. ICR can extend repayment periods for up to 25 years—even for relatively low loan balances—and trigger substantial negative amortization for high-balance loans. It could also lead to hefty tax liabilities for heavily indebted borrowers or those who opted to pursue low-paying public-service careers. Moreover, ICR's complex system for determining monthly payments is likely to prove administratively cumbersome, vulnerable to fraud and abuse, and costly to taxpayers. Worse still, the heavy promotion of ICR could invite overborrowing by students and inadvertently fuel the current intergenerational shift in the responsibility for paying for college from parent to student.

Notwithstanding the specific critique of ICR, income-based repayment in general has its place among payback options and can substantially lessen the monthly repayment obligation for borrowers in special need of this form of relief. Properly designed, appropriately marketed, and promoted in a way that its terms are fully disclosed, income-based repayment can be a useful debt-management tool that should be equally available to all borrowers served under the federal student loan programs.

Background

Today, federal education loans account for more than half of the financial aid awarded to students,² and the typical debt load for undergraduates now exceeds \$10,000.³ Income-based repayment has had a checkered history. It was first proposed more than four decades ago. Early proponents, including Nobel laureate Milton Friedman, argued that, because education boosts lifetime earning power, students should be allowed to match their loan payments to their enhanced income stream.⁴ In more recent times, the case for income-based repayment has centered around the idea that it enables "students to borrow more, but share with society the risk of a poor financial return on a

college education by allowing lower repayments when borrowers' incomes are lower."⁵

The federal government initiated a demonstration program at ten postsecondary institutions in 1986, but the project was terminated prematurely in 1992 and the findings were inconclusive. Some have feared income-based repayment would ultimately become a replacement for federal grant assistance. Indeed, a writer for *The Washington Monthly* as recently as April 1997 endorsed such a move, terming the income-contingent loan plan "relatively cheap" as compared to tax breaks or grant increases.⁵ Student groups were cautious in their initial support for ICR because of the potential for greater involvement by an "unfriendly" Internal Revenue Service (IRS) in loan servicing and collection and in opposition to a proposed option of employer withholding of student loan payments.⁶

Today, however, the concept of income-based repayment is acknowledged by most as at least a useful option for a student borrower to fall back on—a "safety net" perhaps for the student with an atypical earnings profile that remains relatively flat over time or for a student who purposefully and admirably seeks to toil in a low-paying, public service career.

In 1993, the Clinton Administration succeeded in making its ICR plan the cornerstone of the newly authorized Direct Loan program. The initial payment rules were set by the Department in mid-1994 following a sometimes-acrimonious debate with representatives of the higher education and loan communities over how to structure the payment formula.⁷ In response to persistent concerns that the plan would result in excessive interest costs and, at the same time, encourage students to borrow more than they could comfortably afford to repay, the Department has twice revised its ICR payment rules.⁸

How ICR Works

For many borrowers, especially those with modest income prospects and heavy debt loads, ICR isn't much of a bargain. ICR's chief attraction is that it establishes a low monthly payment at the outset. Under the government's payment rules, the monthly ICR installment cannot exceed 20% of the borrower's discretionary income. The monthly installment is expected to rise in tandem with increases in the borrower's adjusted gross income (AGI). Other repayment plans—for example, graduated repayment and income-sensitive repayment—offer reduced payments in the early years of the loan. Aside from authorized periods of forbearance, the ICR plan is the first to build periods of negative amortization into the design of its repayment tables. Negative amortization occurs when a borrower's monthly payment is insufficient to cover the accruing interest.

The amount of negative amortization can be substantial. Payments under ICR can be as low as \$5 a month, even in cases where the borrower owes tens of thousands of dollars. If the borrower's income falls below the poverty level, ICR rules allow the borrower to waive the monthly payment. This no-payment period is not considered a period of deferment or forbearance. Moreover, under the plan's repayment rules, it is possible for the monthly installment to be less than the accruing interest *throughout the life of the loan*.

Negative amortization can greatly increase interest costs, because unpaid interest charges can be added to the principal balance. The borrower is then subjected to compounded interest charges—paying interest on interest. Be-

cause of the potential for prolonged negative amortization, ICR regulations limit capitalization of accrued-but-unpaid interest to no more than 10% of the initial loan balance. Thus, a borrower's principal balance cannot exceed 110% of the initial loan balance. This interest capitalization limit will ameliorate the effects of compounded interest charges. Triggering the limit on capitalization of interest, however, will not stop the ticking of the interest meter. Unpaid interest continues to be added to the total loan balance. Until the monthly payments become sufficient to cover the accruing interest, the borrower's unpaid balance will continue to grow.

ICR's interest damage is front-loaded. Negative amortization in the initial years of a loan will significantly increase total interest charges. For instance, consider a borrower who leaves school with \$35,000 in loans and then takes a \$20,000 a year teaching job in Appalachia. Assuming the interest rate holds constantly at 8.25% and the teacher receives a 5% pay raise every year, the monthly payment won't be enough to cover the accruing interest until the beginning of the fifth year. In the meantime, the loan balance will have increased by about \$1,000. As a result, the borrower will have to continue making payments for an additional 19 years. Over the life of the loan, the borrower will make payments totaling \$84,352, including \$49,352 in interest. During this period, the monthly installment amount would rise from \$204 to \$356. Alternatively, under a 20-year, level-payment plan calling for a monthly payment of \$298, the borrower could expect to pay just \$36,573—a full one-fourth less—in interest charges.

Conversely, ICR may be too costly in terms of the monthly payment burden for borrowers with strong income prospects, because the payment structure works essentially like a tax. As shown in Tables 1 and 2, the more a borrower earns, the higher the monthly payment. Under the ICR formula that took effect July 1, 1996, the monthly payment is determined by multiplying the amount required to repay the loan in equal monthly installments over 12 years (144 payments) by a percentage factor determined by the borrower's adjusted gross income. These factors range from about 55% to 200% of the 12-year payment amount. The Department has adopted two rate tables, one for single borrowers and one for married borrowers and single heads of households.

As shown in Table 1 on the following page, a borrower's monthly payment for a particular debt level increases with income. A borrower with a debt of \$75,000 and a starting salary of \$30,000 a year would be required to make initial monthly installments of \$371. Yet the initial payment for a borrower earning \$70,000 a year is \$1,038, \$216 more than the payment needed to pay off the \$75,000 debt in full within 12 years. The payment would continue to increase, and the loan will be repaid in about eight years. At very high levels of income, the monthly payment becomes twice the 12-year payment amount. Although accelerating the payback period will minimize total interest costs, the annual increases in the monthly payment could be viewed as an economic hardship by borrowers trying to harness their discretionary incomes to purchase a car, home, pay for child care, or save for their children's education.

The income percentage factors are lower for borrowers who are married or are single heads of households. (See Table 2 on the following page.) The Department reasoned that the ICR formula should take into account the fact

“For many borrowers, especially those with modest income prospects and heavy debt loads, Income Contingent Repayment isn't much of a bargain.”

TABLE 1
Initial Monthly Income Contingent Payments for Single Borrowers

Adjusted Gross Annual Income	Income Contingent Repayment Income Percentage Factor	Initial Loan Balance (12-Year Payment Amount)					
		\$5,000 (\$ 55)	\$10,000 (\$ 110)	\$15,000 (\$ 165)	\$25,000 (\$ 274)	\$50,000 (\$ 548)	\$75,000 (\$ 822)
\$ 7,740	55.45%	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
\$ 10,000	57.75%	\$ 32	\$ 38	\$ 38	\$ 38	\$ 38	\$ 38
\$ 15,000	64.58%	\$ 35	\$ 71	\$ 106	\$ 121	\$ 121	\$ 121
\$ 20,000	75.05%	\$ 41	\$ 82	\$ 123	\$ 204	\$ 204	\$ 204
\$ 25,000	84.46%	\$ 46	\$ 93	\$ 139	\$ 231	\$ 288	\$ 288
\$ 30,000	92.09%	\$ 50	\$ 101	\$ 151	\$ 252	\$ 371	\$ 371
\$ 40,000	100.00%	\$ 55	\$ 110	\$ 164	\$ 274	\$ 538	\$ 538
\$ 50,000	110.98%	\$ 61	\$ 122	\$ 182	\$ 304	\$ 608	\$ 704
\$ 60,000	119.56%	\$ 66	\$ 131	\$ 197	\$ 328	\$ 655	\$ 871
\$ 70,000	126.93%	\$ 70	\$ 139	\$ 209	\$ 348	\$ 696	\$ 1,038
\$ 80,000	133.49%	\$ 73	\$ 146	\$ 220	\$ 366	\$ 732	\$ 1,098
\$ 90,000	140.06%	\$ 77	\$ 154	\$ 230	\$ 384	\$ 768	\$ 1,151
\$100,000	146.60%	\$ 80	\$ 161	\$ 241	\$ 402	\$ 804	\$ 1,205
\$150,000	177.26%	\$ 97	\$ 194	\$ 291	\$ 486	\$ 972	\$ 1,457
\$187,364	200.00%	\$ 110	\$ 219	\$ 329	\$ 548	\$ 1,096	\$ 1,644

Assumptions: Borrower is single and has no dependents. The interest rate is 8.25%.

Source: U.S. Department of Education.

TABLE 2
**Initial Income Contingent Payments for Married Borrowers
Or Single Heads of Households**

Adjusted Gross Annual Income	Income Contingent Repayment Income Percentage Factor	Initial Loan Balance (12-Year Payment Amount)					
		\$5,000 (\$ 55)	\$10,000 (\$ 110)	\$15,000 (\$ 165)	\$25,000 (\$ 274)	\$50,000 (\$ 548)	\$75,000 (\$ 822)
\$ 10,360	55.00%	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
\$ 15,000	62.06%	\$ 34	\$ 34	\$ 34	\$ 34	\$ 34	\$ 34
\$ 20,000	71.37%	\$ 39	\$ 78	\$ 117	\$ 117	\$ 117	\$ 117
\$ 25,000	81.28%	\$ 45	\$ 89	\$ 134	\$ 200	\$ 200	\$ 200
\$ 30,000	91.27%	\$ 50	\$ 100	\$ 150	\$ 250	\$ 284	\$ 284
\$ 40,000	100.00%	\$ 55	\$ 110	\$ 164	\$ 274	\$ 450	\$ 450
\$ 50,000	106.99%	\$ 59	\$ 117	\$ 176	\$ 293	\$ 588	\$ 617
\$ 60,000	115.80%	\$ 63	\$ 127	\$ 190	\$ 317	\$ 635	\$ 784
\$ 70,000	124.59%	\$ 68	\$ 137	\$ 205	\$ 341	\$ 683	\$ 950
\$ 80,000	130.99%	\$ 72	\$ 144	\$ 215	\$ 359	\$ 718	\$ 1,077
\$ 90,000	137.28%	\$ 75	\$ 150	\$ 226	\$ 378	\$ 752	\$ 1,129
\$100,000	141.77%	\$ 78	\$ 155	\$ 233	\$ 389	\$ 777	\$ 1,168
\$150,000	159.90%	\$ 88	\$ 175	\$ 263	\$ 438	\$ 876	\$ 1,315
\$200,000	189.49%	\$ 104	\$ 208	\$ 312	\$ 519	\$ 1,039	\$ 1,558
\$217,763	200.00%	\$ 110	\$ 219	\$ 329	\$ 548	\$ 1,096	\$ 1,644

Assumptions: Household size is two. The interest rate for determining the 12-year payment is 8.25%.

Source: U.S. Department of Education.

that borrowers with families have less discretionary income available for student loan payments.⁹ Because changes in borrowers' marital status are likely to affect household income and student debt levels, the two-tier payment factor system could have dramatic effects on their ICR payments. For example, a single borrower earning \$30,000 a year would be required to make a payment of \$371 to repay a debt of \$50,000. Marriage to an individual earning \$50,000 would result in a near doubling of the borrower's monthly payment, to \$718. In effect, under ICR, the borrower's new spouse will be required to help repay the borrower's student loan. Current ICR regulations stipulate that the income of a borrower's spouse must be considered when determining student loan payments under ICR. This rule was implemented to ensure the Department had the ability to accurately assess the borrower's household income¹⁰ (and thus limit the ability of individuals to avoid repaying their loans by shifting income to spouses and filing separate tax returns.)

Marriage, however, could have odd effects in cases where both spouses have student debts to repay. Consider the impact of marriage on ICR payments of a husband with \$50,000 in debts and an income of \$30,000 a year and a wife with \$25,000 in debts and an income of \$50,000. Before the wedding day, the couple's combined payments would be \$675, or about 11% of their combined incomes. Yet, the first annual payment adjustment after the wedding will raise their monthly payment to \$1,077, or 17% of their joint income. This reflects the inherent bias of the income percentage factors toward accelerated repayment at higher income levels. In this situation, a couple in need of payment relief is likely to switch to the extended repayment option, which could reduce their combined monthly installments to as low as \$607.

Having children could alter ICR payment schedules, since household size is a factor in determining borrowers' discretionary income levels. Divorce and a subsequent remarriage can also shift payment streams. As a result, borrowers could see their payments rise, fall, and then rise again in response to shifts in their household status.

Unrealistically Low Payment Schedules For Low-Income Borrowers

Under ICR's current rules, borrowers with low incomes may not be able to repay in full loan balances as low as \$655 despite making payments for 25 years. For borrowers at the lower end of the income scale, The Department's income percentage factors are designed to decelerate the payback of student loans. The Department's *1996-97 Repayment Book* projects that a borrower earning \$15,000 a year will fail to completely repay in full a \$15,000 loan balance, assuming a 5% annual increase in salary and a constant interest rate of 8.25%. The booklet does not specifically mention the amount of the unpaid balance, instead choosing to disclose that, over the course of 25 years, the borrower will pay \$36,047—more than double the face value of the original loan note. Of this amount, \$24,190 will be devoted to interest payments and only \$11,857 to repaying the principal.¹¹

The projected unpaid balance, of course, is the difference between \$15,000 and \$11,857. Because of the long-term interest charges, more than one-fifth of the principal—\$3,143—never gets repaid. This amount will be forgiven. Under current law, forgiven debts must be treated as taxable income.¹² Thus, assuming a 15% tax rate, the borrower should be prepared to pay an additional \$471 in federal income taxes for the year in which the loan balance is forgiven.

“Many borrowers do not have full and complete information when selecting income contingent repayment.”

What is more damaging to this borrower is the amount of interest paid to service the debt over a 25-year period. Because the ICR formula ever-so-gradually increases the monthly payment, from \$106 in the first year (on a monthly gross income of \$1,250) to \$136 in the 25th year (on a monthly gross income of \$4,032), the borrower is forced to pay \$24,190 in interest costs. This is not the result of negative amortization, since the monthly payments are always sufficient to cover the accruing interest. Instead, ICR's interest costs are triple the standard plan's projected interest tab of \$7,077 because the monthly installment amount is rising by just \$1 per year. In contrast, the extended repayment and graduated repayment schedules available under the Direct Loan program offer substantial monthly payment relief, and, at the same time, enable the borrower to repay the loan in full within 15 years. As a result, total interest charges are remarkably lower, \$11,194 for extended repayment and \$13,628 for graduated repayment (again, assuming a constant interest rate of 8.25%).

The required payments are growing very little each year, even for certain categories of borrowers whose incomes are rising 5% every year. Thus, less income (not more), on a percentage basis, is going toward repaying the loan while interest costs continue to mount. In the previous example, the percent of monthly income the borrower is devoting to paying the loan falls from 8.5% in Year 1 to just 3.4% of monthly income in the 25th and final year.

Comparing this schedule to graduated repayment in the chart below, monthly payments for the borrower who elects the graduated repayment plan, rise from \$105 in Year 1 (8.4% of income) to \$238 in year 15 (9.6% of income). Meanwhile, this borrower saves approximately \$10,000 in total interest costs and faces no potential extra tax liability.¹³

ICR's unrealistically low payment schedules will affect low-income borrowers by causing them to make payments for a full 25 years. In such circumstances, most of the borrower's payments—25 years' worth—will be allocated to interest payments, which, under current law, cannot be deducted from the borrowers' taxable incomes. Indeed, using the Department's assumptions regarding income growth and interest rates, borrowers with starting incomes of \$15,000 would fail to completely repay debts as low as \$655. Single borrowers seeking to repay amounts of \$18,000 or more will experience negative amortization and can expect to leave substantial unpaid balances.

Borrowers who leave unpaid balances will not suffer the stigma of default, since their balances will be canceled. However, if they are unable to pay the

Comparative Growth in Loan Payments

Year of Repayment	GRADUATED		INCOME CONTINGENT	
	Monthly Payment	% of Income	Monthly Payment	% of Income
1	\$105.10	8.4	\$106.22	8.5%
5	\$132.90	8.7	\$110.00	7.2
15	\$238.29	9.6	\$122.01	4.9
25	N/A	N/A	\$135.98	3.4

income taxes on the forgiven balances, they will be subject to the collection efforts of the Internal Revenue Service, which has the power to seize assets and garnish wages.

A longstanding rationale for extended repayment of a loan—be it a car loan, home loan, or student loan—is that, due to inflation, the borrower is paying back the loan with cheaper dollars. At first glance, “present value” theory would suggest that ICR would indeed offer such a less expensive repayment option, but this isn’t necessarily the case. Under ICR, the borrower’s payments continue to rise with increases in income. (If the economy is experiencing inflation, the borrower’s income is likely to be rising.) Depending on the borrower’s initial debt, income and income growth prospects, these payments may eventually exceed, by substantial margins, the amount paid under the traditional level-payment plan.

Also, because ICR payments are adjusted annually, it is possible for the present value of the borrower’s monthly payment at the beginning of a new payment year to be higher than the present value of the previous month’s payment. In contrast, the present value of a payment made under the standard, equal-installment plan will always be lower than the present value of the previous month’s payment. Because ICR payback schedules are affected by a variety of factors, including the initial debt-to-income ratio, the inflation rate, the growth rate for the borrower’s income, and the rate of interest, there is no simple formula for estimating the present value of a borrower’s ICR payments.

There is, of course, an opportunity cost to be considered. The lower payments offered by ICR, at least during the initial years of the payback schedule, will free discretionary income. This income could be invested. However, for many, if not most, students, the boost to their take-home pay will be small, perhaps \$15 or less. Over time, the difference between the ICR payment and the equal-installment payment will diminish, lessening the likelihood that this money will be allocated to savings. An extra \$10 or \$20 is most likely destined for current consumption—food, clothing, or a trip to the cineplex. Even if the money is saved, the after-tax rate of return on small-dollar investments is likely to be less than 8.25%. On this basis, these borrowers would strengthen their financial position by using the extra funds to accelerate, rather than delay, the payoff of their student loans.

That said, ICR—or for that matter, an extended repayment or graduated repayment plan—may provide temporary relief to financially-strapped borrowers who are carrying high balances on their credit cards, especially cards charging annual interest rates of 18% or more. For the same reason, it would make more sense to repay a home loan over 30 years in order to accelerate the repayment of a student loan, especially since the home’s value is likely to keep pace with inflation and the interest payments on the mortgage may be deducted from the borrower’s taxable income.

Many borrowers do not have full and complete information when selecting ICR. “In promoting ICR as a ‘more affordable’ option, official materials do not place sufficient emphasis on the potential long-term borrower costs of this repayment plan.”¹⁴ The Department of Education’s *1996-97 Repayment Book* includes a repayment table to help borrowers compare their monthly payments and total payments under four different repayment options: standard (10-year),

Insufficient Information

“Income Contingent Repayment could create economic incentives to overborrow and transfer the burdens of paying for college from parents to students.”

extended, graduated, and income contingent repayment. This table shows initial monthly payments and total payments in a variety of repayment scenarios.

Though the Department’s *Repayment Book* for the Direct Loan program briefly mentions that borrowers who use ICR face the possibility of negative amortization (i.e., payments too low to cover the accruing interest), and that a loan not repaid in full after 25 years is canceled (i.e., forgiven) with the unpaid balance subject to tax, the accompanying repayment tables leave out important information.

The tables do not project the yearly increases in the monthly payment under either the graduated plan or ICR. They do not indicate that at least a third of the ICR scenarios will leave unpaid balances; nor mention the possibility of an unpaid balance. Amazingly, the table offers no explanation, not even in the footnotes, about the fact that, in some of the ICR scenarios, the borrowers’ total payments fall short of the initial loan balances.¹⁵ Uninformed borrowers may inadvertently conclude that ICR is their best option because they do not have to repay all of their debts.

Table 3 shows the projected unpaid balances that would result for borrowers who have initial incomes of \$15,000 a year. Heavily indebted borrowers will leave huge unpaid balances and, thus, face, tens of thousands of dollars in extra tax levies. The Department does not have the responsibility for collecting these taxes. As noted earlier, the borrowers must deal with the IRS.

Inadequate disclosure of ICR’s true costs could prompt many students to borrow more than they need or more than they can comfortably afford to repay. Although the Department has amended the payment formula to discourage overborrowing, the changes may not be enough to offset the consumers’ perceptions that ICR makes it less expensive to borrow more money for school. Ironically, the more students borrow to fund their education, the greater the danger that they will be forced to select ICR as their repayment option.

The Direct Loan program rules permit borrowers to switch from one repayment plan to another. Borrowers who enjoy substantial increases in their earnings can trade their ICR repayment terms for standard, extended, or graduated repayment terms. However, the longer borrowers remain in ICR, the harder it will be for them to switch to another payback plan. That’s because the time spent in ICR will reduce the available payback period under any of the other options on a month-for-month basis.¹⁶

For example, a borrower who uses ICR for three years would have only seven years to repay the remaining balance under the standard, 10-year payment plan. The shortened payback period, thus, could mean a big jump in the monthly payment—possibly higher than if the borrower had started out in one of the other plans. In short, some borrowers may discover too late that they are stuck with ICR.

Taxpayers, however, may decide they do not have to be stuck with ICR, especially when they realize that they will have to pay interest on the extra Treasury securities that must be sold to support nonperforming ICR loans and then, 25 years from now, absorb the cost of forgiven loan balances. If a substantial number of heavily-indebted borrowers experience prolonged negative amortization under ICR, the aggregate cost to taxpayers could very well be staggering.

TABLE 3
ICR's Hidden Costs:
Projected Unpaid Balances for Single Borrowers
With Initial Annual Incomes of \$15,000

Initial Loan Balance	Total Projected Payments	Projected Unpaid Balance	Projected Tax Liability
\$ 2,500	\$ 6,009	\$ 520	\$ 78
\$ 5,000	\$12,016	\$ 1,047	\$ 157
\$ 7,500	\$18,025	\$ 1,566	\$ 235
\$ 10,000	\$24,032	\$ 2,094	\$ 314
\$ 15,000	\$36,048	\$ 3,140	\$ 471
\$ 20,000	\$47,596	\$ 7,431	\$ 1,115
\$ 25,000	\$57,373	\$ 21,631	\$ 3,245
\$ 30,000	\$65,526	\$ 31,977	\$ 4,797
\$ 40,000	\$77,469	\$ 53,752	\$14,771
\$ 50,000	\$84,261	\$ 78,573	\$22,000
\$ 75,000	\$86,751	\$157,559	\$48,843
\$100,000	\$86,751	\$239,035	\$66,930

Assumptions: Borrower's income grows 5% annually. Interest rate is held constant at 8.25 %.
Tax liability projections are based on current law (see endnote 12).

Note: Projections are based on the results of a computer simulation model.

ICR's Complexity: A Double-Edged Sword

Income Contingent Repayment's complicated payment formula and participation rules will confuse borrowers and, at the same time, create opportunities for fraud and abuse. The sheer complexity of the ICR repayment formula, which requires information from the Department of Health and Human Services, the Department of Labor, the IRS, and the Department of Education, makes the plan virtually impossible for student borrowers to fully decipher on their own. Just figuring the initial payment requires at least a half-dozen computations.

Moreover, the Department of Education does not appear to be sharing all of the assumptions it must make in projecting future loan payments under ICR. For example, the Department's repayment table states that income is assumed to grow 5% a year. However, the Department does not disclose its assumption for changes in the Consumer Price Index, which help determine the income percentage factors used to calculate the borrower's monthly payment. Yet, even if borrowers knew this, few possess the math skills, computer know-how, or patience needed to make their own calculations. Financial aid administrators are not likely to have the resources needed to help students analyze this repayment option in full.

The cost of administering an income contingent plan is likely to be considerable. The Department must collect income data from the IRS, a process that requires the written consent of the borrowers. In cases where the borrowers have not yet filed their own tax returns, the Department must find ways to verify the borrowers' current incomes. Once a year, the Department must recalculate ICR payments, taking into account changes in income and shifts in borrowers' household size and marital status, as well as changes in the interest rate and the inflation rate.

“Students should be encouraged to look at all other repayment options, including forbearances.”

Ironically, ICR's complex payment rules may invite opportunistic or unscrupulous individuals to use this payment plan to legally renege on their promise to repay their school debts. Because of ICR's tax-like payment system, some borrowers may seek to avoid repaying their loans under ICR by shielding income or shifting income to others. Such tactics, of course, will have several undesired effects for U.S. taxpayers.

First, such behavior will reduce student loan payments to the Department of Education. Second, reduced loan payments for heavily indebted borrowers will increase the amount of forgiven loan balances. Taxpayers will have to bear up to 85% or more of these amounts. Third, student loan payment avoidance will reduce general tax revenues.

Only time will tell the extent to which ICR is vulnerable to fraud and abuse, but warning signs are beginning to appear. The Department has already disavowed a recently published book that tells students how to take advantage of ICR's payment rules, especially the provision that forgives unpaid balances after 25 years of payments.¹⁷ In a tape-recorded marketing message, the book's author actually advises individuals to sign up for ICR quickly because Congress is likely to end the program when it learns how much it is costing taxpayers.¹⁸

There is concern, too, that, seven years from now, the Department will see a marked increase in bankruptcy filings by student borrowers. Under current federal rules, individuals may petition bankruptcy courts to discharge federal student loans that have been in repayment for at least seven years. Because ICR would enable some borrowers to make minimal or zero payments throughout the seven-year waiting period, it is possible for these borrowers to declare bankruptcy and avoid making any substantial payments toward their student loans.

ICR has also offered defaulted borrowers an avenue to legally avoid having to repay their debts to the government. Indeed, in January 1996, the Office of Inspector General (OIG) instructed the Department officials to stop offering ICR, via consolidation loans, to borrowers who have defaulted on their federal education loans. The OIG cited concerns that ICR did not enhance the ability of the Department to reduce federal losses on defaulted loans. Because of ICR's repayment formula, many of these borrowers are making minimal, if any, payments on their consolidation loans. The OIG contends that the federal fiscal interest would be better served by subjecting defaulted borrowers to administrative wage garnishments. This would allow the federal government to claim 10% of a defaulted borrower's wages.¹⁹

Aside from the potential for abuse, recent reports published by economists at the nonpartisan Congressional Research Service (CRS) attempted to quantify the added cost to the government of rules inherent to ICR that leave the government shouldering some of the accrued interest not charged to the borrower (due to the capitalization limit on negative amortization previously discussed) as well as forgiveness of any unpaid loan balance remaining after the maximum 25-year repayment period. The government incurs these costs “all without declaring a formal default,” noted the CRS economists. Thus, the CRS report concluded that “these additional costs would imply a 24.7% higher effective default rate than for the standard repayment option.”²⁰

While insufficient data is available from the Department to accurately

predict the potential taxpayers' exposure based on this 24.7% higher "effective" default rate, a rather rough "guess estimate" can be derived primarily from figures publicly available from the Department of Education's Website.²¹ Based on the cumulative number of borrowers selecting ICR (from July 1, 1994 to November 30, 1996), the government's higher "effective" costs of default in ICR are approximately \$26 million.²²

Given that elsewhere in the CRS report, the economists estimate that the average borrower is in school a period of three years, this figure of \$26 million could also be a reasonable gauge of the government's cost of ICR (over and above other repayment options) for every year's cohort of borrowers entering repayment. If anything, this is a relatively low estimate of the potential long-term annual taxpayers' exposure when the program is fully up and running. Moreover, the CRS analysis warns that should "a law be adopted forgiving taxes owed on the unpaid loans" as currently proposed by the Department of Education, "the program costs attributable to (FDLP) could rise substantially."²³

Unintended Effects

Economists and higher education policy experts have discussed other potential consequences of ICR. The plan could create economic incentives to overborrow and transfer the burdens of paying for college from parents to students. Two papers commissioned by the Department of Education make a similar prediction that ICR "will increase both the willingness of students to borrow and the willingness of parents to pass the burden on."²⁴ Because the ICR plan is an option available to students only, Martin Kramer says the plan will "materially bias the financing system in the direction of student credit financing and against parent financing."²⁵ Sandy Baum sees an even more far-reaching effect, noting that "the extended repayment period will seriously erode the possibility of borrowers saving for their children's education."

While acknowledging that the goal of the ICR plan "is to change economic behavior" by making the choice of a low-paying public service job more feasible for a graduate with a large loan balance, Rudolph G. Penner, a former Director of the Congressional Budget Office, is concerned that ICR may also create a disincentive to "work one's way up the career ladder."

He notes that the government's "tax and transfer system" is already very destructive to incentives to work for those at the low end of the income distribution. In an example of a couple with one child earning \$20,000, they are "likely to see over 40 cents of each additional dollar earned disappear into the tax system." If, between them, this same couple had "income-contingent loans of \$20,000, an extra dollar earned will raise their student loan repayment by 20 cents." Thus, this family keeps only 40 cents of each additional dollar earned—"a significant disincentive to be productive," Penner argues.²⁷

Baum would seem to agree, noting the ICR program "has a potentially negative effect in terms of efficiency, since there is no penalty for students who choose to invest in human capital with a low rate of return" for society.²⁸ Penner's own view is that "a direct subsidy to the socially desirable activity" in the form of loan forgiveness for certain public service jobs (as has been tried with doctors practicing in medical shortage areas) "would be much more cost effective."²⁹

Suggested Improvements

Notwithstanding the specific critique of the ICR payback formula, income-based repayment in general has its place among the repayment options available to student borrowers. For that student with a high loan debt and modest income prospects or for a student who admirably seeks to toil in a low-paying, public service career, the monthly repayment relief can be considerable under ICR.

The desire to lessen one's monthly repayment burden needs to be balanced, however, with the negative effect of incurring higher total interest charges through this means. Materials available from the Department need to be strengthened to better inform borrowers about this trade off as it relates to the potential long-term borrower costs of the ICR plan.

Still the best advice to give students entering repayment—which is the advice that financial aid administrators and student loan lenders give routinely—is to *pay off their loans as quickly as their financial circumstances permit in order to avoid paying higher total interest charges*. Fortunately, there is an array of tools, including user-friendly student loan repayment calculators on the World Wide Web, to help students fully assess their options about most of the available plans. Also, through the Federal Family Education Loan Program, there are a growing number of tangible rewards—in terms of reduced interest rates and loan fees—for encouraging students to repay their loans consistently on-time.

Borrowers pondering ICR because of an inability to afford the monthly payment costs of other available repayment plans should also be advised that they can obtain a “forbearance” and set payments at any level—or suspend their payments entirely—for an agreed-upon period. The loan would accrue any unpaid interest in this case, but it would be for a short-term period when the borrower is in special need of repayment relief.

With the right program modifications, the anomalies in the Department's current repayment formula for ICR can be fixed; repayment materials can provide borrowers with a more complete picture of the long-term impact of ICR; the potential taxpayer burden can be lessened; and the benefits of income-based repayment can and should be equally applied to borrowers under both guaranteed and direct loans. The guaranteed student loan community has already proposed a number of these refinements in a set of federal loan program recommendations for Reauthorization of the Higher Education Act submitted to the Congress on April 2, 1997.³⁰ Consistent with these recommendations, I would urge the following:

- **Make Income Contingent Repayment truly income-contingent.** The improper indexing in the current plan is easily fixed, according to Rudolph Penner, by indexing the initial loan amount for inflation as well as the income brackets.³¹ If the borrower can be shown that payments will be roughly x percent of income, this will go a long way in making the option more readily understandable.
- **Reduce the opportunity for negative amortization.** Shifting the repayment formula to begin with a minimum payment of \$30 rather than the current \$5 will help minimize the amount of time that borrowers will be in negative amortization (e.g., when payments don't even cover the

interest that is accruing) without being much more onerous for the borrower (who, by the way, could still negotiate a “forbearance” and pay as little as zero during times of severe distress).

- **Establish certain debt-to-income eligibility criteria.** Taxpayers should be assured that this future benefit of “loan forgiveness” is reaching only those who need it—borrowers with high debt and low or modest income earning prospects.
- **Impose a limit on the amount forgiven.** Set sufficiently high to cover most borrower situations, a limit on the amount forgiven after 25 years would be more equitable and, according to Penner, avoid “rewarding profligate borrowing.”³²
- **Base the repayment formula on total reported income.** Basing the formula on what is called “total income” on the IRS Form 1040 rather than AGI would minimize any “gaming” of the tax system to reduce one’s student loan payout.
- **Appropriately market ICR as an option of last resort.** For many students—especially the very students who borrow a lot of money to go to school, but who do not earn a lot of money after they graduate—ICR is among the most costly ways to pay back student loans. Students should be encouraged to look at all other repayment options, including forbearances, to determine if they can manage the monthly payback under the other plans that, most of the time, will end up costing them a great deal less in total interest charges.
- **Make the revised ICR plan available to all federal student loan borrowers.** While the FFEL Program community offers an Income Sensitive Repayment method, ICR has certain advantages written into the law that Income Sensitive Repayment does not. ICR should be available as well for the vast majority of students who will repay their loans under the FFEL Program. To surmount one supposed legal hurdle centered around “income verification,” IRS data that is provided to the Secretary or copies of the borrowers’ tax returns could serve as the basis for determining a borrower’s payment under the guaranteed loan community’s version of ICR.³³

Properly designed, appropriately marketed and promoted in a way that its terms are fully disclosed, income-based repayment can be a useful debt-management option for certain student borrowers and their families.

Appendix

Model Methodology

The preceding analysis is based on a computer spreadsheet model of the Income Contingent Repayment (ICR) plan under the Federal Direct Loan Program. The model computes monthly payments and total interest costs for *single borrowers* making the following assumptions:

1. The borrower’s income increases at a 5% annual rate. This is the same

rate used by the Department of Education in compiling the ICR projections provided in the *1996-97 Repayment Book*.

2. The threshold level for a poverty-level income rises at an annual rate of 3%. The Department does not disclose its assumptions for the change in the threshold level for poverty-level incomes, but based on results produced by the model, it appears that the Department assumes an increase of 3% per year.

3. The income levels used in the income payment factor tables are projected to increase at a constant annual rate of 3%. Again, the Department is silent about this assumption, but the model's results indicate that the Department is using a 3% rule.

4. The interest rate is held constant at 8.25% over the life of the loan. The Department's projections are based on this assumption.

5. The income percentage factor is always applied against the monthly payment that would be required to repay the initial loan balance in equal installments over 12 years, even though federal regulations stipulate that the payment base must be adjusted upwards after periods of negative amortization. This assumption was chosen because the model's results clearly indicate that the Department is also using this assumption.

6. Monthly payments cannot exceed 20% of a borrower's discretionary income.

7. The monthly payments are adjusted once a year.

8. Interest capitalization cannot exceed 10% of the initial balance. Unpaid interest in excess of the 10% cap is added as simple interest (thus there is no additional interest compounding on these interest charges). Interest is capitalized annually, at the same time the monthly payment is adjusted.

The model seeks to project total payments and interest costs by determining the monthly payment for each year the borrower is in repayment under the ICR plan and tracking the resulting decrease or increase in the loan balance.

The results of the spreadsheet model closely match the initial payment and total payment projections provided by the Department of Education's *1996-97 Repayment Book*. In some cases, the model's results may vary by a couple dollars; these differences probably reflect slight differences in rounding rules. The ability of the model to match the initial payment and the total payment projections in virtually every one of the 36 different repayment scenarios strongly suggests that the model's assumptions are essentially the same as those used by the Department of Education. Even slight deviations in key assumptions result in substantial variances from the Department's projections.

Note: The analysis found a significant exception—the scenario in which the borrower starts with an income of \$25,000 and a debt of \$50,000. This exception is difficult to explain because the model matches results for higher and lower debt amounts for borrowers at the \$25,000 income level. This discrepancy is under study.

Endnotes

1. "An Examination of the Long-Term Costs to Student Borrowers of Income Contingent Repayment Under the Federal Direct Loan Program," National Council of Higher Education Loan Programs, Education Finance Council and Coalition for Student Loan Reform, November, 1996, p. 1. (see <http://www.cslr.org/incomecontingent.htm>)
2. *Trends in Student Aid: 1986-1996*, The College Board, September, 1996, p.3.

3. "How Much Do Students Borrow to Fund an Undergraduate Degree?" a statistical report published in August 1996 by USA GROUP, Inc.
4. *Issues in Designing a Federal Program of Income-Contingent Student Loans*, CBO Memorandum, Congressional Budget Office, January 1994, p. 1.
5. *Issues in Designing a Federal Program of Income-Contingent Student Loans*, p. 9.
6. Letters to The Honorable Bill Clinton, President, from the United States Student Association (dated October 14, 1994) and the National Association of Graduate-Professional Students, Inc. and the American Medical Student Association (dated October 20, 1994).
7. "ACE Balks at Income Contingent Plan," *Fed Notes*, June 24, 1994.
 - "Joint statement from AASCU and USSA in response to Clinton Administration's income contingent repayment plan," issued by the American Association of State Colleges and Universities and the United States Student Association, September 1, 1994.
 - U.S. Representative Thomas E. Petri, "The Administration's Plan for Implementing Income Contingent Student Loans Is in Serious Trouble," a "Dear Colleague" letter to Members of Congress, June 27, 1994.
 - Mike Sherry, "Direct Student Repayment Talks Fizzle," *Education Daily*, July 15, 1994.
 - Jim Zook, "Disputes Continue on Repayments in New Loan Plan," *The Chronicle of Higher Education*, July 20, 1994.
8. U.S. Department of Education, 34 CFR Part 685, William D. Ford Federal Direct Loan Program, Final Regulations, *Federal Register*, Vol. 59, No. 230, December 1, 1994, pp. 61664-61711.
 - U.S. Department of Education, 34 CFR Part 685, Vol. 60, No. 231, December 1, 1995, pp. 61820-28.
 - (See also: U.S. Department of Education, 34 CFR Part 685, Vol. 61, No. 119, June 19, 1996, pp. 31358-62.)
9. U.S. Department of Education, 34 CFR Part 685, Vol. 60, No. 231, December 1, 1995, pp. 61821-22.
10. U.S. Department of Education, 34 CFR Part 685, Vol. 60, No. 231, December 1, 1995, pp. 61822-23.
 - U.S. Department of Education, 34 CFR Part 685, Vol. 60, No. 182, September 20, 1995, pp. 48848-49.
11. *1996-97 Repayment Book*, William D. Ford Federal Direct Loan Program, U.S. Department of Education, pp. 7-15.
12. The Clinton Administration's current tax reform package, "The Hope and Opportunity Act of 1997" (H.R. 1233), proposes an amendment to current law to remove any tax liability on the student loan principal forgiven after 25 years under ICR. The prospects for this legislative relief are unclear; it likely will be resisted by those who fear the change in tax law would set a negative precedent for the treatment of the forgiveness of other debts owed the U.S. Government.
13. "An Examination of the Long-Term Costs to Student Borrowers of Income Contingent Repayment Under the Federal Direct Loan Program," p. 3.
14. "An Examination of the Long-Term Costs to Student Borrowers of Income Contingent Repayment Under the Federal Direct Loan Program," pp. 7, I-ii.
15. *1996-97 Repayment Book*, p. 15.
16. U.S. Department of Education, 34 CFR Part 685, Vol. 59, No. 230, December 1, 1994, p. 61700.

17. An Internet message sent July 1, 1996, by Deb Schweikert, a direct lending official at the U.S. Department of Education, states: "Re: Diamond Incorporated. . . This is a definite ripoff. While we have no jurisdiction to stop this young man. . . we are trying to inform schools that this is a 'buyer beware' situation and are also trying to get info out on the net, the bulletin board, etc. warning anyone who will listen *not* to publish the book."
18. The toll-free line for the tape recorded message has been disconnected. The book is *Student Loan Rescue*, by Dr. David Klein (Diamond Publishing, Carson City, Nevada, 1996).
19. "Cost Analysis of the Department's Initiative to Consolidate Debt Collection Service Loans Into the Direct Loan Program," an audit report published January 1996 by the Office of the Inspector General, U.S. Department of Education, pp. I-ii.
20. Barbara Miles and Dennis Zimmerman, *Reducing Federal Student Loan Costs: The Options Are Narrowing*. Congressional Research Service, CRS Report 97-255 E, February 25, 1997, pp. 23, 28-29.
21. "Opening Wide the Doors of College," U.S. Department of Education, 1997, p. 1. (see <http://www.ed.gov/updates/Pre-EDPlan/part9.html>)
22. U.S. Department of Education figures as of November 30, 1996, show that ICR is chosen by 52% of borrowers in the Direct Consolidation Loan program and by 1% of non-consolidation FDLP borrowers in repayment. Using these percentage factors and on the basis of other data available about the amount of loans and number of borrowers who have consolidated under FDLP as of November 1996, potential defaults from ICR borrowers can be roughly estimated at \$106 million of which \$26 million represents the higher "effective" default rate projected by Congressional Research Service economists Barbara Miles and Dennis Zimmerman.
23. Miles and Zimmerman, p. 23.
24. Sandy Baum, *New Directions in Student Loans: Intergenerational Equity*, commissioned by the Planning and Evaluation Service, Office of the Undersecretary, U.S. Department of Education, 1994, p. 6. (see <http://www.ed.gov/offices/OUS/eval/baum.html>)
25. Martin Kramer, "Direct Student Loans in the Changing Landscape of Higher Education Finance," commissioned by the Planning and Evaluation Service, Office of the Undersecretary, U.S. Department of Education, 1994, p. 4 (see <http://www.ed.gov/offices/OUS/eval/kramer.html>)
26. Baum, p. 6.
27. Rudolph G. Penner, "Income Contingent Loans: An Analysis of the Potential Taxpayer Costs under the Current Program," Barents Group, 1997, pp. 9-11.
28. Baum, p. 7.
29. Penner, p. 11.
30. "Meeting the Education Finance Needs of Students and Parents," Recommendations for Reauthorization of the Higher Education Act submitted by Sallie Mae, Education Finance Council, Consumer Bankers Association, Student Loan Servicing Alliance, Coalition for Student Loan Reform and the National Council of Higher Education Loan Programs, Inc., April 2, 1997, p. 4.
31. Penner, p. 4.
32. Penner, p. 11.
33. "Meeting the Education Finance Needs of Students and Parents," p. 4.