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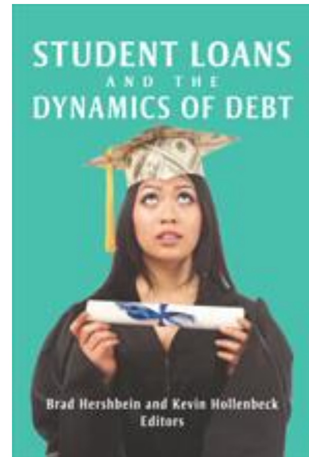

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Student Loans and the Dynamics of Debt

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11
Federal Student Loan Policy

Improving Loan Design, Repayment, and Consumer Protections

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The need for higher education and training has never been as important to individuals and our economy as it is today, yet its affordability is seriously in question. College costs have skyrocketed, as family incomes and state funding for public higher education have declined, leading millions to take on student debt, drop out, or struggle to keep up with classes while working many hours per week to pay the bills. Even after recent significant increases, the maximum Pell Grant today covers the smallest share of the cost of attending a public college since the start of the program 40 years ago. It should be no surprise that the gaps in college enrollment, persistence, and graduation between students from high- and low-income families have widened over the last 30 years, threatening both the American Dream and our nation's economic competitiveness.

Although these gaps cannot be closed with financial aid policy alone, research shows that it can increase enrollment and completion. This chapter focuses specifically on student loan policy at the federal level and offers a number of recommendations to reduce complexity, improve targeting, contain debt burdens, and encourage completion and wise borrowing. These recommendations are part of a comprehensive package of reforms to federal student aid, detailed in our 2013 white

paper, *Aligning the Means and the Ends: How to Improve Federal Student Aid and Increase College Access and Success* (The Institute for College Access and Success [TICAS] 2013). Unless otherwise noted, the information in this chapter is drawn from that paper.

BACKGROUND

As context for our recommendations, we provide some brief background information about federal and private student loans.

Federal Student Loans

The current federal student loan program is too complex, its benefits are poorly targeted, and its terms are too arbitrary. Much of the complexity is a holdover from when banks received subsidies to make Stafford Loans with terms set and guaranteed by the government. The resulting rules shielded banks—but not borrowers or taxpayers—from risk. Now that these federal loans are made directly and more cost-effectively by the U.S. Department of Education, the entire student loan system can and should be streamlined and improved.

From the myriad types and terms of different loans to the repayment process, it can be hard to figure out how federal student loans work. Consider, for example, the main source of undergraduate loans since July 2010: the Direct Stafford Loan program. There are "subsidized" and "unsubsidized" Stafford Loans, each with different eligibility criteria and treatment of interest during school and periods of deferment and with separate caps on how much a student can borrow each year and cumulatively. The vast majority (82 percent) of undergraduates with subsidized loans also have unsubsidized loans, so some of their loans accrue interest while they are in school and some do not.[1]

Subsidized loans currently provide students with valuable benefits, including a low fixed interest rate and no interest accrual while they are in school.[2] However, these benefits are not well targeted, as high-income students may qualify just because they attend a high-cost college, and most students with subsidized loans also have unsubsidized loans.

All Stafford Loans offer flexible repayment plans, as well as loan deferments and forbearances, yet more than one in eight student loan borrowers is defaulting within three years of entering repayment.[3] The consequences of defaulting on a federal loan can follow borrowers for the rest of their lives, ruining their credit, making it difficult to buy a car or rent an apartment, and limiting their job prospects. They may also face garnished wages, seized income tax refunds, and diminished Social Security checks.

Private Loans

Private educational loans are a much riskier way to pay for college than federal student loans. Most private loans have variable, uncapped interest rates and require a cosigner (U.S. Consumer Financial Protection Bureau and U.S. Department of Education 2012). No more a form of financial aid than a credit card, private loans typically have interest rates that, regardless of whether they are fixed or variable, are highest for those who can least afford them. Private loans lack the basic consumer protections and flexible repayment options of federal student loans, such as unemployment deferment, income-driven repayment, and loan forgiveness programs.

RECOMMENDATIONS

Reform is clearly and urgently needed. Our loan recommendations aim to better support access and success while containing costs and risks for both students and taxpayers. To achieve those goals, we propose simplifying the loan program, improving the targeting of benefits, containing debt burdens, and encouraging wise borrowing. Our recommendations include the following:

- Provide a single undergraduate student loan with no fees, a low in-school interest rate, and a fixed rate in repayment that is never much higher than the rate on loans being offered to current students.
- Streamline and improve federal loan repayment options.

- Improve the timing, content, and effectiveness of student loan counseling.
- Reduce the number of student loan defaults.
- Reform the student loan collections process.
- Strengthen consumer protections for private loan borrowers.

One Simple, Affordable Undergraduate Loan Program

We propose replacing the current Stafford Loans with one simple, affordable undergraduate loan. Our recommended changes are designed to simplify the loan program, ensure that loans both appear and are affordable for borrowers, and better align the cost of the loan for the student with the costs for the government. There is no way to perfectly balance all three of these goals. However, what we propose is an important step forward on each front, focused on making federal student loans a more effective tool for ensuring access and supporting success while containing risk for both the student and the taxpayer.

Specifically, we recommend that there be only one federal loan for undergraduate students, in place of the subsidized and unsubsidized Stafford Loans available today. A single loan will be much easier for borrowers to understand and monitor, and for schools and the Department of Education to administer. This loan—which we refer to in this chapter as the One Loan—has an interest rate that is lower while the student is in school and higher by a set margin, but capped, when the borrower enters repayment. The interest rates are tied to the government's cost of borrowing and designed to help offset the cost of the loan program, rather than being arbitrarily set by Congress.[4] The features of One Loans are described in the sections below.

Fixed interest rates and no fees

Fixed rates are important to provide certainty, predictability, and reassurance to students, many of whom have never borrowed before and may not fully understand the consequences of variable rates. The recent mortgage crisis demonstrated all too clearly that millions of Americans with mortgages did not understand the risks of variable rates, with terrible consequences for both them and our nation's economy. Fixed interest rates also further distinguish One Loans, which are a form of

financial aid, from other financial products such as credit cards and private loans. As mentioned earlier, interest rates on private loans are usually variable, like a credit card. The private loans that offer fixed rates will almost certainly have higher interest rates than One Loans for all borrowers except those who have, or whose cosigners have, pristine credit. At the height of the lending boom in 2007–2008, a majority of private student loan borrowers had not taken out as much as they could have in federal loans first, underscoring the need to clearly distinguish federal student loans from private loans (TICAS 2011a).

The One Loan's fixed rate is tied to the government's cost of lending in the year the loan is disbursed. For instance, the interest rate on all loans disbursed in a given school year might be set based on the interest rate on the one-year Treasury bill or 10-year Treasury note at the final auction preceding June 1 of that year. Students who take out One Loans each year that they are in school may end up having loans with different interest rates, depending on the market conditions each year. However, all the other terms of their One Loans would be the same.

There is no reason for the new loan to have fees, which are remnants of the bank-based guaranteed loan program and add unneeded complexity to the loan. The fixed interest rate will be set to cover the cost of One Loans without needing to add supplemental fees.

Low in-school interest rate

The in-school interest rate on One Loans is based on the government's actual cost of borrowing when the loans are made. The rate for new loans would take effect each year on July 1 and apply to all loans issued through June 30 of the following year. The in-school rate applies while the borrower is enrolled at least half-time and during a six-month grace period after she leaves school, similar to the usual timing of the interest subsidy on subsidized Stafford Loans. Having a lower interest rate when students are in school is intended to encourage them to stay enrolled and complete their education, knowing that their interest rate will rise if they stop out or drop out.[5] Lower in-school interest rates also help encourage the use of federal loans over private loans or other types of financing available to consumers with limited or no credit histories. Charging a low in-school rate, rather than charging no interest, while the student is enrolled is designed to both lower the cost of providing the loan and discourage students from dragging out their time in school.

Higher, but capped, out-of-school rate

The One Loan's out-of-school interest rate is set at the in-school rate when the loans were taken out, *plus* a fixed margin designed to cover the cost of the loan program, including the interest-rate insurance described below, loan forgiveness and discharge, and administrative costs. For example, imagine a One Loan with an in-school interest rate of 3 percent based on the government's cost of borrowing that year. If, for illustration purposes only, the repayment rate were set at the in-school rate plus two percentage points, it would have an out-of-school interest rate of 5 percent. The out-of-school rate, while higher than the in-school rate, must be low enough to ensure that federal loans are—and look like—financial aid in contrast to other types of financing such as private loans.

The out-of-school interest rate on the One Loan will be subject to a universal cap, like Stafford Loan interest rates; currently the undergraduate Stafford Loan interest rate is capped at 8.25 percent.[6] A universal cap protects consumers from extremely high rates in the economy and reinforces the differences between federal loans and commercial financial products. For example, if the universal cap were 7 percent, the in-school interest rate were 6 percent, and the repayment rate set at the in-school rate plus two percentage points, the loan would have an out-of-school interest rate of 7 percent because the cap would keep the rate from rising above 7 percent.

Interest-rate insurance

The One Loan has an important new feature: a form of insurance that prevents interest rates from ever being too much higher than the rate on loans being offered to current students. This feature addresses the major disadvantage of fixed rates for borrowers, without requiring refinancing or consolidation. To prevent borrowers from getting stuck with high fixed rates when market rates decline significantly, the interest rate on One Loans will reset to a lower fixed rate when interest rates in the economy drop substantially from when the loan was issued.

For example, the interest-rate insurance might prevent outstanding One Loans from having a rate that is more than two percentage points above the rate on loans being offered to current students. If a borrower had a One Loan with an out-of-school interest rate of 6.5 percent, and

interest rates dropped so that the One Loans to current students had an out-of-school rate of 3.8 percent, the borrower's interest rate would automatically drop from 6.5 percent to 5.8 percent, so that the rate was no more than two percentage points above the current rate.

The interest rate on affected One Loans would not increase, even if rates in the economy do. This helps borrowers who go to school when interest rates are unusually high, while avoiding the uncertainty and risk of a variable rate for all borrowers. We believe this interest rate insurance, which has some similarities to existing financial instruments (e.g., swaptions) can be provided at a reasonable cost to both borrowers and taxpayers, and incorporated into the fixed margin in the out-of-school interest rate.[7] The cost of this feature will depend on the selected interest rate margin, universal cap, and the specifics of the insurance.

Interest-free deferments for Pell Grant recipients

In addition to the One Loan's low in-school rate, universal interest rate cap, and interest rate insurance, which apply to all borrowers, the One Loan provides additional protection to borrowers from low-income families. Pell Grant recipients who take out loans would be eligible for interest-free deferments during periods of unemployment and economic hardship, just as with subsidized Stafford Loans currently.[8]

Subsidized Stafford Loans do not accrue interest while the borrower is in school, during the six-month grace period, or when payments are deferred for certain reasons after the borrower leaves school, including periods of unemployment and the first three years in IBR or PAYE if income-driven payments are less than monthly interest.[9] However, as mentioned above, these valuable benefits are not well targeted for several reasons: high-income students may qualify for subsidized loans just because they attend a high-cost college; and the vast majority of students with subsidized loans also have unsubsidized loans, which accrue interest during these periods.

The One Loan better targets these valuable benefits to the borrowers who most need them, when they need them most. Borrowers who received Pell Grants, by definition, come from low- and moderate-income families and are therefore much less likely to have family members who can support them during periods of unemployment or low earnings. The loans will provide interest relief on all loans held by Pell

Grant recipients, rather than just some of their loans, when they are unemployed or their incomes are too low to cover their interest in an income-driven repayment plan.

Retain current loan limits

The loans will have the same aggregate loan limits as Stafford Loans: currently $31,000 for dependent undergraduates and $57,500 for independent undergraduates. Student loans have become a fact of life for more and more Americans, and there is widespread and understandable concern about high and pervasive debt levels. Federal loan limits provide a necessary signal to students and colleges about how much borrowing might be too much. The higher loan limits for independent students rightly recognize that these students have greater financial responsibilities and may need to borrow more to stay and succeed in school.[10]

Some have suggested raising the current loan limits, while others have suggested lowering them, but the data do not support either suggestion (TICAS 2012a,b). As mentioned earlier, average debt for 2011 graduates of public and nonprofit four-year colleges was well below the aggregate limits—the average including private loans was $26,600 for the two-thirds who borrowed, and one-third of graduates had no student debt (TICAS 2012c). The majority of undergraduates who borrow private education loans could have borrowed more in federal student loans before turning to the riskier private market (TICAS 2011a). Finally, colleges already have the authority to limit or deny loans for individual students on a case-by-case basis (TICAS 2012d).

The Department of Education should, however, analyze the potential effects of prorating federal student loans by attendance status. Unlike Pell Grants, federal loans are not prorated based on a student's attendance status. In other words, students enrolled half time receive a prorated portion of the Pell Grant that students enrolled full time receive, but may receive the same loan amount as a full-time student. Students who take out full loans but make only part-time progress may be at an increased risk of dropping out and defaulting. Students who attend college part time are less likely to complete a degree or certificate (U.S. Department of Education 2011), and failure to complete a degree or certificate is one of the strongest predictors of future default

(Nguyen 2011; Gross et al. 2009). They may also be at greater risk of exhausting their loan eligibility before completing their degree. Prorating loans would involve reducing student eligibility for federal loans at a time when college is getting harder to afford, but it is possible that it could help encourage students to enroll in more courses per term, thereby completing a degree and reducing their risk of default. Given both the risks and the potential benefits, such a change warrants careful analysis and consideration.

Streamline and Improve Federal Loan Repayment Options

We have identified several ways to simplify and improve federal loan repayment options to help borrowers manage their debt, and reduce the financial distress and defaults that undermine the goals of increased enrollment and completion. There is even more complexity on the repayment side of the federal loan process than on the borrowing side. The number of repayment options and the variation in eligibility requirements, costs, and benefits can be overwhelming, even for those working in the field. With so many choices and variables, comparisons can become unwieldy and confusing, and borrowers may be more likely to end up in plans that do not fit their needs or goals. However, having some well-designed choices, combined with timely and effective counseling, can help borrowers find a good fit for their own situation, stay in repayment, and avoid default.

Let borrowers make one loan payment for all their federal loans

To reduce complexity and make it easier to stay current on their loans, we recommend that borrowers be able to make a single payment that covers all of their federal loans. Currently, this can only be accomplished through a separate consolidation process, which is a significant bureaucratic hurdle for borrowers and has trade-offs that are not in every borrower's best interest.[11] Borrowers should not have to consolidate their loans just to avoid making multiple payments to multiple servicers on their federal student loans each month.

Base repayment plan eligibility on total federal loan debt

The "standard" repayment plan for unconsolidated federal loans is currently a 10-year plan. Borrowers are automatically enrolled in this plan if they do not actively choose a different one before their first payment (U.S. Department of Education 2013a). If borrowers owe more than $30,000, they may be able to choose an "extended" 25-year plan instead, but only if they owe that much within one loan program.[12] For example, if they owe $31,000 in the Federal Family Education Loan Program (FFELP) or $31,000 in Direct Loans, they may qualify for the extended plan. But if they owe $15,000 in Direct Loans and $16,000 in FFELP Loans, they do not qualify. In contrast, total federal student loan debt, along with the borrower's income, is used to determine eligibility for income-driven repayment plans, in which borrowers pay for up to 20 or 25 years.[13] Meanwhile, borrowers who combine their loans into a Direct Consolidation Loan have access to "standard" repayment plans that gradually increase from 10 to 30 years depending on the borrowers' total federal loan debt.[14] Any signal to borrowers about optimal repayment periods, if one were ever intended, gets lost in all this complexity, and what is optimal to one borrower may not be for another.

Instead, we recommend that all borrowers have access to repayment plans based on their *total* federal student loan debt, with incrementally longer repayment periods available to those with larger total debt. Making these repayment options consistent for all loans would greatly simplify the process for borrowers, especially when paired with improved loan counseling that helps them identify their priorities and see which plan is the best fit. Borrowers who want to reduce the overall cost of their debt by paying it down faster will be able to select shorter repayment plans and make prepayments without penalty, as they can now. Borrowers who want assurance that their monthly payments will remain affordable, given their income, will have access to a streamlined income-driven plan, as discussed in detail below. Additionally, borrowers who want all their payments to count toward Public Service Loan Forgiveness will always be able to choose a 10-year payment plan.[15]

Currently, as mentioned above, borrowers who do not select a repayment plan are automatically placed in a 10-year plan, making it the "default" plan. A 10-year plan has significant benefits for borrowers *if* they can afford the monthly payments, which are higher than the

monthly payments in longer plans. Given the growth in student debt levels over the past generation, a 10-year plan may be increasingly unrealistic for many borrowers.[16] Automatically enrolling borrowers in this plan, regardless of their total debt levels, could be setting some borrowers up to fail.

Nevertheless, there are trade-offs between shorter and longer repayment plans. Longer repayment periods provide lower monthly payments but also cost borrowers more over the life of the loan. The best plan for one borrower may not be the best for another borrower. The decision of which repayment plan is most appropriate for any given borrower—whether made by the individual or by the Department of Education through the selection of a "default" or mandatory plan—is important and needs to be considered carefully. As we discuss later in the chapter, loan counseling should be improved to help borrowers decide which plan is best for them. The Department of Education should also carefully analyze data on borrowers' repayment plan choices and outcomes—including their ability to make payments and total amount paid—to determine whether a 10-year plan remains the best option for borrowers who do not actively select another plan. It should also consider the broader implications of changing the default repayment plans for borrowers, colleges, and taxpayers.

Give all borrowers access to a single, improved income-driven repayment plan

When Congress created the Income-Based Repayment plan (IBR) for federal loans in 2007, it was a major step forward for student loan borrowers.[17] TICAS, through its Project on Student Debt, developed the policy proposal that laid the groundwork for IBR (TICAS et al. 2006). We first consulted with stakeholders on all sides and conducted an in-depth analysis of debt burdens and repayment plans. This analysis found that protections and options for borrowers with high debt relative to their income were inadequate, inconsistent, and inaccessible (TICAS 2006). With America's higher education system increasingly reliant on student loans, and the consequences of default so severe and long-lasting, students were bearing too much of the risk to ensure access or support success. We developed a "Plan for Fair Loan Payments" that called for affordable payments based on income and family size, cover-

age of both Direct and FFELP Loans, and a light at the end of the tunnel with forgiveness after 20 years of income-driven payments. These goals were supported by thousands of students, higher education leaders, loan industry representatives, civil rights groups, Republicans and Democrats in Congress, and organizations representing parents, college counselors, and others.[18]

Thanks to the broad coalition that helped make the case for a solution, IBR became available to all federal loan borrowers in July 2009 (TICAS 2009). Despite the absence of much publicity or borrower outreach in the first few years of the program, more than 1.3 million borrowers were enrolled in IBR by the winter of 2012 (U.S. Department of Education 2013b). IBR caps monthly payments at a manageable share of income and forgives any principal or interest that remains after 25 years of payments. To qualify, borrowers must have a "partial financial hardship," defined as a debt-to-income ratio that makes a 10-year payment unaffordable. Required payments can be as low as $0 for borrowers with very low incomes, and payments rise incrementally with income. Payments are capped at the lower of the monthly payment under the standard 10-year plan, or 15 percent of "discretionary income," which is defined as adjusted gross income (AGI) minus 150 percent of poverty for the borrower's family size.[19]

In recent years, the number of repayment options similar to IBR has grown. In early 2010, Congress passed the president's proposal to expand IBR for future borrowers (White House 2010). Starting in July 2014, new borrowers will be able to qualify for a lower monthly payment and shorter forgiveness period than the current IBR program provides: 10 percent of discretionary income and 20 years, instead of 15 percent and 25 years. In the fall of 2010, President Obama announced a new Pay As You Earn plan to give an estimated 1.6 million current students and recent graduates access to the same lower payment cap and shorter forgiveness period, with the goal of offsetting the recession's effect on their job prospects and earnings (White House 2011 and TICAS 2012f). To qualify for Pay As You Earn, students must have borrowed their first loan after September 30, 2007, and received at least one federal loan disbursement after September 30, 2011. Pay As You Earn became available to eligible borrowers in December 2012 through regulatory additions to a preexisting program called Income-Contingent Repayment (ICR), which is only available for borrowers with Direct Loans.[20]

ICR, which is still available, provides less relief than IBR in most cases. Direct Loan borrowers in any of these repayment plans who *also* work for public or nonprofit employers may have their loans discharged after just 10 years of payments, through the Public Service Loan Forgiveness plan Congress created at the same time as IBR.[21]

We recommend consolidating the well-intentioned, but highly complex, mix of currently available income-driven plans—current IBR, IBR for new borrowers in 2014, Pay As You Earn, and ICR—into one new and improved income-driven plan. Borrowers would no longer have to figure out which plans they qualify for or which of their loans will be covered by which payment cap or forgiveness period. Those already enrolled in IBR, Pay As You Earn, and ICR would have the option of staying put or switching to the new plan. For the purposes of this chapter, we refer to the new plan as Pay As You Earn 2 (PAYE2).

To simplify, strengthen, and improve access to income-driven payments, PAYE2 will be available to all borrowers, regardless of their debt or income level, whether their loans are Direct or FFELP, or when they borrowed. This will make it much easier for borrowers who want the assurance of manageable payments to 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. Rather than requiring borrowers to have a certain debt-to-income ratio to enroll, borrowers with higher incomes relative to their debt will simply make larger payments as determined by the plan's sliding scale. This is already the case for those whose incomes rise substantially after they entered an income-driven plan. If borrowers have access to even lower monthly payments in another plan, and that is more important to them than the assurance of income-driven payments, they need not enroll in PAYE2.

Enabling all borrowers to enroll in PAYE2 will likely require adjustments in some aspects of income-driven plan design, such as the treatment of accrued interest, when to capitalize interest and how much, and whether and how borrowers can exit and reenter PAYE2. Further study is needed to determine optimal approaches. These changes will affect the benefits and risks of widespread enrollment in PAYE2.

PAYE2 will ensure that payments never exceed 10 percent of income while better targeting benefits. In its current design, Pay As You Earn has undeniable benefits for low- and moderate-income borrowers,

but it may also result in some high-income borrowers getting substantial forgiveness when they could well afford to pay more. PAYE2 includes two adjustments that better target benefits while assuring that monthly payments never exceed 10 percent of the borrower's income and avoiding arbitrary cliffs, in which borrowers in very similar situations get very different benefits.

1) Gradually phase out the "income exclusion" for higher-income borrowers. PAYE2, like IBR and Pay As You Earn, calculates monthly payments based on the borrower's "discretionary income"—AGI minus an "income exclusion"—to protect income needed to cover basic living expenses. Currently, in IBR and Pay As You Earn, the income exclusion is 150 percent of the poverty level for the borrower's household size. Based on this definition, a borrower with a family of four and an AGI of $40,000 has $34,575 protected for basic living expenses. The family therefore has a discretionary income of $5,425, or $452 per month, so payments set at 10 percent of discretionary income would be $45 per month.[22]

   However, as borrowers' incomes rise, it becomes increasingly unnecessary to shield a share of their earnings. Borrowers with very high incomes are able to devote a larger share of their total incomes to loan payments and still have sufficient funds left over to cover basic necessities, such as food and housing. As a result, PAYE2 gradually phases out the income exclusion for borrowers with AGIs between $100,000 and $250,000, so that borrowers with AGIs of $250,000 or more would have their monthly payments calculated as 10 percent of their total AGI. Borrowers with AGIs below $100,000 would not be affected, and monthly payments for all borrowers would never be greater than 10 percent of their total income. The AGI levels at which the phase-out begins and ends would be indexed to inflation to ensure fairness over time.

2) Cap all monthly payments at 10 percent of income.

   Currently, in IBR and Pay As You Earn, some borrowers can end up paying less than 10 percent of their income, owing to a certain cap on their monthly payments. This occurs if, after entering IBR or Pay As You Earn, the borrower's income rises

> high enough that he no longer has a "partial financial hardship" (i.e., his debt-to-income ratio has declined so much that a 10-year payment is now affordable). When this occurs, his payments are capped at the monthly amount he would have had to pay had he entered a 10-year standard repayment plan when he entered IBR. For some high-income borrowers, this cap will be lower than 10 percent of their incomes. Removing the current 10-year-payment cap and instead capping payments at 10 percent of income better targets income-driven repayment benefits to those who need them and prevents high-income borrowers from receiving substantial loan forgiveness when they could have afforded to pay more.[23]

Additionally, PAYE2 will provide forgiveness after 20 years of payments. As we have long recommended, any debt remaining after 20 years of income-driven payments should be discharged. This will make it easier for borrowers to see the light at the end of the tunnel, and let them focus on saving for retirement and their children's education before the next generation is in college. The changes to payment determinations described above better target the forgiveness available after 20 years because higher-income borrowers will be more likely to pay off their debts within that period.

Furthermore, we recommend making it easier for all borrowers in income-driven plans to keep their income information up to date. Regardless of how many income-driven plans there are, there is a need to further improve the process through which borrowers provide updated income information to their loan servicers. Currently, borrowers in income-driven plans must provide tax or other income information each year to avoid reverting to non-income-driven payments that may be much higher than they can afford. Recent improvements require that borrowers be notified before they have to submit information and make it easier for some borrowers to submit it to their servicer (U.S Department of Education 2012a). Additionally, in late 2012, the Department of Education launched a user-friendly tool that lets borrowers electronically transfer their own tax information from the Internal Revenue Service (IRS) into an online form, both to apply for income-driven plans and to update their income information (U.S. Department of Education 2012b). Unfortunately, this process is only available to borrowers who have filed an IRS 1040 form. Borrowers with incomes too low to owe

federal income tax may not have a 1040 form to draw from, requiring them to go through extra steps to verify their incomes. As a result, borrowers with the greatest need for income-driven payments may have the hardest time continuing to qualify for them.

To simplify the process for all borrowers, the income verification process for PAYE2 should enable borrowers to draw on earnings data in their W-2 and 1099 forms. In addition, borrowers should be able to give the Department of Education advance permission to access their AGI and W-2 information for some period of time (e.g., five years), as they could until recently for IBR and ICR, to reduce the risk of inadvertently missing a deadline.

Finally, any forgiven loan balances should not be treated as taxable income. Borrowers currently enrolled in IBR, ICR, and Pay As You Earn, as well as those who would be enrolled in our proposed PAYE2 plan, can have their loan balances forgiven after 20 or 25 years (depending on the program) of qualifying payments. Treating discharged loans as taxable income creates a tax liability that most recipients will be unable to afford, discourages enrollment in income-driven repayment plans, and is inconsistent with the treatment of other discharged loans.[24]

Improve the Timing, Content, and Effectiveness of Student Loan Counseling

Federal law and regulations require entrance and exit counseling for any student who receives a federal loan.[25] Entrance counseling has the potential to help students optimize their borrowing and better understand the risks and benefits, and exit counseling has the potential to help students select an appropriate repayment plan and avoid default. However, the timing and content of required counseling must be improved to better help students borrow wisely, complete college without burdensome debt, and repay their loans. With common-sense modifications and more research on what works, loan counseling can more effectively inform crucial decisions about borrowing and repayment.

Loan counseling should be conducted when it is most likely to have an impact: *before* students commit to borrowing. Currently, entrance counseling can occur after the promissory note is signed, as long as the counseling comes before the first loan disbursement. This timing problem can and must be fixed. Also, whereas entrance counseling is

only required when students first borrow, interim counseling should take place at key points when borrowers are likely to benefit, such as when they have borrowed over a certain amount or sought certification of a private loan.

To be more effective, loan counseling must be individualized based on the borrower's specific situation and needs; it should not just disclose general information and options. Entrance counseling could give students an estimate of their total debt burden if they borrow the amount they are seeking in each year they plan to be in school and also provide the resulting monthly and total payments under different plans. Exit counseling could ask students about their plans and preferences and point them toward specific repayment plans based on this information. For instance, if a student has borrowed a small amount and has secured a job with sufficient pay, the counseling might encourage her to select a 10-year fixed payment plan to minimize the total amount she will pay over the life of the loan. On the other hand, if the student has borrowed a large amount and is unsure how much she is likely to earn, the counseling might highlight income-driven repayment as a way to keep her payments affordable. Currently, counseling does not have to be tailored to the individual student's situation and can, for example, use average loan amounts rather than the amount the student has actually borrowed.

Entrance and interim loan counseling should include warnings about the risks of private loans and discourage students from considering them if they have not exhausted their federal loan options. Students need to understand the protections and benefits that come from federal loans, including set and predictable interest rates, flexible repayment plans, deferment options, and forgiveness programs, *before* they take out a private loan. To the extent possible, exit counseling should include any private loan debt so students can select a repayment plan for their federal loans based on an understanding of their total debt, including any private loans.

Finally, all loan counseling should be consumer tested and improved based on feedback, and ongoing analysis should be conducted of counseling's impact on student decisions. For instance, existing data systems could be used to assess the impact of variations in entrance, interim, and exit counseling on student enrollment, persistence, borrowing, repayment, and default rates. Such analysis could be used to continually improve the counseling to better support student success, prevent loan

defaults and unwise or unnecessary borrowing, and reduce the burden of student debt by helping students choose appropriate repayment plans.

Strengthen Consumer Protections

We recommend strengthening consumer protections to support smart borrowing, to prevent default, and to reduce the financial distress of borrowers with federal and private loans.

Federal loan borrowers

As a form of financial aid, federal student loans provide many important consumer protections that are not required of private education loans or other types of financing. Examples include discharges under circumstances such as school fraud, school closure, severe and permanent disability, or death; income-driven repayment plans that help ensure affordable payments and a light at the end of the tunnel; deferments and forbearances that let borrowers temporarily suspend payments without becoming delinquent or paying additional fees; and an opportunity to reenter repayment after default. Such policies are supposed to prevent or reduce defaults, unfair treatment, and extreme financial distress for borrowers who used federal loans to help pay for their own or their child's education. Unfortunately, the federal loan system does not work as well as it should to protect borrowers in challenging circumstances. The recommendations presented in this section are aimed at reducing red tape for distressed, disabled, or defrauded federal loan borrowers and reducing and preventing defaults. While far from comprehensive, these recommendations touch on several important areas for improvement in ways that address the interests of both borrowers and taxpayers.

Respond to signs of financial distress in ways that can prevent default.

- *Ensure that borrowers receive key information about their repayment options not only before they make their first payment but also when their payment patterns indicate likely financial distress.* For example, in 2012, a dozen members of Congress urged the Secretary of Education to alert borrowers to the avail-

ability of IBR and related plans as soon as those borrowers have been delinquent, in forbearance, or in economic hardship or unemployment deferment for more than 60 days (U.S. House of Representatives 2012).[26] Despite efforts to make repayment more manageable, default rates have risen even among those who entered repayment after IBR became available (TICAS 2012e). Borrowers struggling to keep up with monthly payments clearly need this information and related counseling. Once distressed borrowers are aware of income-driven repayment and how it could help them, they might also benefit from information about extended repayment plans, deferments, forbearances, and conditions for cancellation.

- *Automatically enroll severely delinquent borrowers in an income-driven repayment plan.* It takes at least nine months of nonpayment to default on a federal student loan. The federal loan promissory note should require borrowers to give the Department of Education permission to access their IRS information if they miss at least six consecutive payments. Using their income and family size, the Department of Education could then determine what their income-driven payment would be.[27] If it were less than their current payment, the Department of Education would notify the borrower and, unless they chose another plan, automatically enroll the borrower in the income-driven plan. For borrowers with very low incomes, income-driven payments may be as little as $0, and income-driven payments will be lower than 10-year payments for most borrowers under financial strain. By enrolling them and engaging in follow-up contact and counseling, the Department of Education may be able to prevent otherwise very likely defaults and the associated costs for both borrowers and taxpayers. Notification and ease of use will be essential to this policy's effectiveness, as borrowers need to know that their payment has been lowered and how and why to update their income and family size at least annually.

Determine why most delinquent borrowers are not successfully contacted before they default. Data show that a significant number of borrowers who default were never successfully contacted by their

lenders because their lenders did not have current contact information (U.S. Department of Education 2010). It will be very difficult to reduce default rates and help more borrowers enroll in affordable repayment plans if servicers and/or the Department of Education lack accurate, up-to-date contact information for federal loan borrowers or functional systems for reaching them. The Department of Education should conduct a study to determine the main causes of this serious problem, use the findings to identify needed changes, make any such changes that are within its authority, and recommend that Congress make additional changes if necessary.

Reconsider the use of private debt collectors for federal student loans. Currently, the federal student loans collections process is almost entirely in the hands of private debt collection agencies (U.S. Department of the Treasury 2009). These debt collectors are given the authority to act on behalf of the lender or guarantor in everything from rehabilitation of a defaulted loan to information about loan discharges to negotiating loan compromises. Because their contracts with the Department of Education provide bigger rewards for collecting larger dollar amounts, these debt collectors have a disincentive to inform borrowers of their rights or to set reasonable and affordable payment amounts based on the borrowers' financial circumstances, as required by law (Hechinger 2012). Given the commission structure and conflicts of interest, it is not surprising that the National Consumer Law Center has found a remarkable amount of deceptive, unfair, and illegal conduct by private collectors involving federal student loans (Loonin 2012). Recent news investigations have also documented such conduct and the underlying "boiler-room" business model (Hechinger 2012 and Martin 2012).

Collections should prioritize the interests of borrowers and taxpayers, not collection agencies. With the Department of Education spending more than $1.4 billion a year on commission-based contracts with private debt collectors, an examination of whether outsourcing is the most effective or appropriate approach is long overdue (Martin 2012). In 2009, the IRS conducted an extensive review of its private collections contracts and moved to bring the function in-house (IRS 2009). The Treasury Department is responsible for the collection of debt owed to the federal government but has delegated to the Education Department

the authority to collect on defaulted student loans.[28] We recommend that the Treasury Department withdraw the delegation of its authority for a randomly selected number of defaulted loans for the purpose of studying whether taxpayers' and borrowers' interests would be better served by collecting all defaulted federal student loans by trained Treasury employees rather than by private debt collectors.

Rethink default penalties to ensure that distressed borrowers have a way out. While there should clearly be some penalties associated with defaulting on a federal student loan, they should not be designed to keep borrowers without financial means in default indefinitely, with already unmanageable debt just continuing to mount. For example, collection fees of up to 25 percent are currently added to what borrowers owe when they default, even if the actual costs of the collections activities are much less.[29] These fees go to the private collection agencies discussed above. If a borrower went into default because she could not afford her loan payments, high fees make it even less likely that she will ever be able to get out of default. Another policy that can trap borrowers in default is limiting them to only one chance at rehabilitation. It is worth considering whether borrowers who redefault should be allowed to rehabilitate their loans more than once after some period of successful payments.

Ensure that borrowers who are abused or defrauded by a college can get relief. The Department of Education should use its full authority to enforce the law that relieves borrowers of debt resulting from illegal or abusive school practices. The "false certification" provisions in law are designed to offer relief for harmed students as well as to discourage illegal, abusive school practices. The law provides for the discharge of loans falsely certified by institutions and for the Secretary to recover the loan amounts from the schools and their affiliates. While the statutory authority is broad, the Department of Education has interpreted these false certification provisions very narrowly, denying needed relief to borrowers who suffered harm at the hands of their school. Borrowers should be eligible for relief if, for example, a school improperly or falsely certifies students' satisfactory academic progress, enrolls students in career education programs that lack the programmatic accreditation necessary for employment in the occupation, enrolls students who do not speak English in programs taught only in English,

or enrolls students with criminal records in programs that prepare them for employment in professions from which they are barred because of their criminal record.[30] The regulations must be revised so that borrowers can count on relief from debts resulting from a school's harmful actions when there is reasonable evidence that the harm took place.[31]

Private loan borrowers

As discussed earlier, private education loans are a much riskier way to pay for college than federal student loans. Whether private loan rates are variable or fixed, lower-income students often receive the worst rates and terms, and private loans do not have the important borrower protections and repayment options that come with federal loans. The following policy changes would help prevent students from unnecessarily taking out risky private loans, ensure that consumers have information they need to make wise borrowing decisions, and stop deceptive and predatory private lending practices.

Prevent unnecessary private loan borrowing by requiring school certification of private loans. The majority of undergraduates who borrow private education loans could have borrowed more in federal student loans before turning to the riskier private market (TICAS 2011a). Unfortunately, many students who borrow private loans—and the parents who cosign these loans—do not understand the difference between federal and private loans until it is too late (TICAS 2011c). Requiring private lenders to confirm a borrower's eligibility with his or her school before disbursing the loan ensures the student is eligible for that loan and the loan amount. It also gives the school a chance to help the student make an informed borrowing decision. Before the credit crunch, about a third of all private loans to undergraduates were made *without* such school certification (U.S. Consumer Financial Protection Bureau and U.S. Department of Education 2012). Currently, most lenders voluntarily ask schools to certify their private loans, but lenders are not required to do so, and changing credit conditions could once again create incentives to cut schools out of the loop. In addition, many schools do not take the opportunity to counsel students before certifying. Students, schools, and lenders, as well as the U.S. Consumer Financial Protection Bureau (CFPB) and the Department of Education, have all endorsed requiring "school certification" of private loans,

including notifying the student of any remaining federal aid eligibility before the loan is certified.[32] The CFPB could require such certification for all private loans, and legislation introduced in 2013 (S. 113 and H.R. 3612) would do so as well (Durbin 2013; Polis 2013).

Treat private loans like other consumer debt in bankruptcy. Since 2005, it has been much more difficult to discharge private education loans than credit cards and other consumer debt in bankruptcy, often leaving even the most destitute borrowers with no way out. A joint report to Congress from the CFPB and Department of Education found that this change coincided with rapid growth in questionable lending practices, compounding the risk to student borrowers (CFPB and U.S. Department of Education 2012). It also found a lack of evidence to support industry claims that restricting bankruptcy rights improved loan prices or access to credit. House and Senate legislation (the *Fairness for Struggling Students Act of 2013* and the *Private Student Loan Bankruptcy Fairness Act of 2013*) would restore fair bankruptcy treatment to private loan borrowers and is supported by TICAS and a broad coalition representing students, consumers, and colleges.[33]

Enable private loan borrowers to refinance or modify their loans. Borrowers who face unmanageably high payments on their private loans do not have access to lower payments through IBR or other federal repayment plans, and private lenders are not required to provide the types of repayment options and borrower protections that are built into federal loans, such as unemployment deferments and forbearances without fees. Private loans typically have variable interest rates that are highest for the students and cosigners who can least afford them. Those who borrowed their loans at a high rate are often unable to refinance despite historically low interest rates in the economy, even if their current credit score would qualify them for a lower fixed or variable rate if they took out a loan today (CFPB 2012). Keeping borrowers locked into high rates and high payments poses risks not only to their ability to meet basic needs but also to retirement savings and homeownership, and to the broader economy as a result (Chopra 2012; CFPB 2012). We recommend that the CFPB and Congress develop standards for loan refinancing and/or modification to make private loan borrowers' debt more manageable.[34]

CONCLUSION

The American Dream envisions a nation where everyone can fully participate in our democracy, and our fates are determined by ability and accomplishment rather than circumstances of birth. Ensuring college access and increasing student success are crucial to achieving and preserving that dream and the economic opportunity and mobility on which it depends. College education is increasingly the primary path to stable employment, higher wages, retirement benefits, and health insurance, as well as a key predictor of civic participation, better health, and the next generation's odds of getting ahead—or at least not falling behind. An educated workforce is also essential to America's economic competitiveness; our nation needs more people to get quality training and education after high school than ever before. However, as college education has become more essential for all these reasons, income gaps in enrollment and completion have widened rather than narrowed.

To meet the broadly shared goal of greatly increasing the share of Americans with a college education, federal student aid policies, including those related to student loans, must be improved to better support access and success for lower-income students. When student financial aid works as it should, students who are willing to study hard can afford to go to college, which is what we mean by college access, and they can complete a meaningful degree or certificate without burdensome debt, which is what we mean by student success.

Notes

1. Calculations by TICAS on 2011–2012 data from the College Board (2012).
2. For more information about both subsidized and unsubsidized Stafford Loans, see http://studentaid.ed.gov/types/loans/subsidized-unsubsidized (accessed June 11, 2014).
3. For the most recent federal loan cohort default rates, see https://studentaid.ed.gov/about/data-center/student/default from the U.S. Department of Education (accessed June 11, 2014).
4. The Bipartisan Student Loan Certainty Act signed into law in the summer of 2013 ties interest rates for new Stafford and PLUS Loans to the 10-year Treasury note yield when the loan was issued, but the rates are still not based on the government's actual cost of lending and running the loan program.

5. This refers to the fact that interest rates for One Loans are lower when borrowers are in school, and higher when they enter repayment. If students discontinue their studies, whether temporarily (stop out) or permanently (drop out), they will no longer qualify for the lower in-school interest rate (though the in-school interest rate will still cover the six-month grace period after students leave school.)
6. Enacted in the summer of 2013, the Bipartisan Student Loan Certainty Act capped interest rates for undergraduate Stafford Loans at 8.25 percent, graduate Stafford Loans at 9.5 percent, and PLUS Loans at 10.5 percent.
7. For information on swaptions, see http://en.wikipedia.org/wiki/Swaption (accessed June 11, 2014).
8. For more information about existing deferments for federal student loans, see http://studentaid.ed.gov/repay-loans/deferment-forbearance (accessed June 11, 2014).
9. The grace period interest subsidy was temporarily eliminated for loans issued in 2012–2013 and 2013–2014.
10. For more information on independent students, see TICAS, Education Trust, and CLASP (2012).
11. For more information about federal loan consolidation, see http://studentaid.ed.gov/repay-loans/consolidation (accessed June 11, 2014).
12. For more information about the extended repayment plan, see http://studentaid.ed.gov/repay-loans/understand/plans/extended (accessed June 11, 2014).
13. All of the borrower's Direct and FFELP Loans count in determining eligibility for IBR and Pay As You Earn, with the exception of Parent PLUS and consolidation loans that repaid Parent PLUS Loans. For more information, see http://studentaid.ed.gov/repay-loans/understand/plans/income-based and http://studentaid.ed.gov/repay-loans/understand/plans/pay-as-you-earn (accessed June 11, 2014).
14. Depending on total educational indebtedness, a borrower with a Direct Consolidation Loan has access to a "standard" repayment period of 10, 12, 15, 20, 25, or 30 years in a non-income-based plan. For more information, see http://loanconsolidation.ed.gov/examples/repyperiod.html from the U.S. Department of Education (accessed June 11, 2014). The Direct Consolidation Loan program defines total debt for this purpose as total Direct Loan debt plus FFELP debt up to the same amount as the Direct Loan total. For more information about the definition, see http://1.usa.gov/WBrewl (accessed June 11, 2014).
15. For more information about the payments that qualify for Public Service Loan Forgiveness, which include 10-year payments and payments made in income-driven plans, see http://1.usa.gov/OjQu3p (accessed June 11, 2014).
16. For example, in 2008, 1 in 10 graduates from four-year colleges had at least $40,000 in student loans, up from just 3 percent in 1996 (using constant 2008 dollars) (TICAS 2010).
17. The IBR plan was created as part of the College Cost Reduction and Access Act of 2007.
18. For more information about the Plan for Fair Loan Payments and support for its goals, see "The Plan for Fair Loan Payments," The Project on Student Debt, http://bit.ly/VLVIbj (accessed June 11, 2014).

19. For more information about IBR, see http://studentaid.ed.gov/repay-loans/understand/plans/income-based and http://IBRinfo.org (accessed June 11, 2014).
20. For more information about ICR, see http://studentaid.ed.gov/repay-loans/understand/plans/income-contingent (accessed June 11, 2014).
21. For more information about Public Service Loan Forgiveness, see http://studentaid.ed.gov/repay-loans/forgiveness-cancellation/charts/public-service and http://www.ibrinfo.org/what.vp.html#pslf (accessed June 11, 2014).
22. Calculations by TICAS based on data from the U.S. Department of Health and Human Services (2012).
23. The Obama administration and others have also proposed eliminating the standard payment cap so that borrowers in income-driven repayment plans are always making payments based on their incomes. See, for example, U.S. Department of Education (2014) and HCM Strategists et al. (2014).
24. The Obama Administration and a bipartisan group of representatives have proposed preventing debt discharged under IDR plans from being considered taxable income. For more information, see U.S. Department of the Treasury (2014) and H.R. 2492 (2009).
25. For information on current loan counseling requirements, see the U.S. Department of Education (2012c). For information on the federal regulations regarding loan counseling, see 34 CFR 685.304, http://bit.ly/XtgttB (accessed June 11, 2014).
26. In the fall of 2013, the U.S. Department of Education reached out by e-mail to over 3 million federal student loan borrowers, including those carrying higher than average debt or showing signs of financial distress, to inform them about income-driven repayment options. See U.S. Department of Education (2013c).
27. Income would be adjusted gross income (AGI) or, if no tax form were available for the past two tax years, wages from W-2 forms. While the family size definition may not be identical to the U.S. Department of Education's definition, it is a proxy under these circumstances and could be amended by the borrower.
28. As specified in 31 U.S.C.§3711: "For purposes of this section, the Secretary of the Treasury may designate, and withdraw such designation of debt collection centers operated by other Federal agencies. The Secretary of the Treasury shall designate such centers on the basis of their performance in collecting delinquent claims owed to the Government."
29. For more information, see https://www.myeddebt.com/borrower/collectionCostsNavigate (accessed June 11, 2014).
30. For examples of teachers being pressured to manipulate grades in order to retain students, see Field (2011).
31. For more information, see comments on false certification in TICAS (2011b).
32. For more information, see the December 10, 2009, letter signed by 25 organizations in support of mandatory certification. See http://bit.ly/Y1qwUN (accessed June 11, 2014). Also see the May 7, 2010, letter signed by lenders and others urging inclusion of mandatory school certification in the Senate financial reform bill, referenced in Lederman (2010).
33. For more information, see the coalition letter to Senator Durbin in support of the Fairness for Struggling Students Act of 2013, available at http://projecton

studentdebt.org/pub_view.php?idx=872 (accessed June 11, 2014), and the coalition letter to Representative Cohen in support of the Private Student Loan Bankruptcy Fairness Act of 2013, available at http://projectonstudentdebt.org/pub_view.php?idx=871 (accessed June 11, 2014).

34. The Refinancing Education Funding to Invest for the Future Act was introduced in the summer of 2013 and endorsed by TICAS. For more information about the bill, see S. 1266 of the act and Brown (2013).

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