

## **The Student PIRGs' Student Debt Alert Campaign Loan Debt Primer**

### **Toward a better way to pay**

#### **Introduction: Why talk about debt?**

As you think about what policies could reduce debt and improve access and affordability, the issue of cost will naturally come up. Obviously, soaring tuition is part of the problem. But it is already one of the Commission's focus areas, and the issue gets lots of public attention as it is. The role of loans and the risks of rising student debt, on the other hand, are not on the Commission's agenda, even though they deeply affect millions of students and their families. Especially now that congress has passed a bill which raises interest rates and the cost of borrowing student loans, it's more important than ever to address the student debt issue.

*Even if tuition froze at today's levels, the need for student loans and the cost of borrowing would continue to rise without major reforms. As long as so many students depend on loans to help pay for the true costs of college, we need to make sure that borrowers aren't condemned to a lifetime of debt, instead of the opportunity and prosperity that higher education is supposed to provide.*

Finally, consider how decisions are made. Tuition at public institutions depends primarily on state budget allocations; at private institutions on decisions made by the school itself. However, the federal government directly controls billions of dollars in grants and loans to college students at all types of institutions across the country. The federal system's approach to debt can be improved on a mass scale through both legislative and regulatory channels.

#### **Getting Started With Solutions to Student Debt at your campus**

Reading through the solutions section as well as the *Student Loan Policy 101* in this primer will show you how the current loan programs work and how complicated they can be. Hopefully it will also give you some new ideas for how to simplify the system and help more students both afford college and get ahead after graduation.

But do not feel locked in to choosing solutions that are listed here. Come up with your own. Ask yourself the following questions: Who needs the most help? Where can changes make the biggest difference? What's not working about our policies now?

Remember to consider new approaches and reforms that you don't find in this guide.

Whatever you come up with, don't get too wrapped up in the details of the policy. Focus on *outcomes* – how your recommendations would affect students and borrowers.

**This guide is broken into three sections:**

- 1. Solutions internationally, nationally and on a campus level to student debt**
- 2. Student Loan Policy 101 – background, definitions**
- 3. Loan and Grant National Chart**

## **SOLUTIONS**

### **International approaches to student debt:**

The governments of other countries use a wide variety of strategies to help student loan borrowers repay their debts and protect them from some of the risks of long-term, unmanageable debt. For more about US policies, see *Student Loans 101* above.

- 1) Low or no interest loans. The Netherlands charged 3.05% interest in 2004. New Zealand charges a rate equal to the government's cost of borrowing, but waives it for low-income students. The United Kingdom charges zero real interest, tying loans to the rate of inflation. Starting July 2007, the US will charge a fixed rate of 6.8% interest on most student loans.
- 2) No payments until earnings reach a minimum level. Many countries do not require borrowers to make payments if their income is below a certain threshold. For a single borrower in Australia, it is \$A 35,000 (about \$US 26,000). In Germany it is €1,520 (about \$US 14,000). In New Zealand it is \$NZ 16,172 (about \$US 11,000). Other countries use complex formulas to calculate this threshold, rather than a set amount. In the UK, it's £15,000 (about \$US 26,500). In the US, borrowers with low incomes have very limited options for delaying or reducing payments.
- 3) Link payment size to income. In New Zealand, after the borrower's income passes the threshold described above, their loan payments are 10% of whatever they earn above that amount. In the UK's new system, they pay 9% of income above the threshold. In Australia, the percentage of income a borrower is required to repay per month rises with income: the minimum is 4%, and the maximum is 8%. For most US borrowers, there is no maximum percentage – you just have to pay.
- 4) Set a maximum repayment period. In some countries, outstanding debts are cancelled after a certain number of years. That period is 25 years in Sweden and the UK, 15 in the Netherlands, and 20 in Germany. In the US, the government can take money out of retirees' Social Security checks if they haven't paid off all their student loans.
- 5) Make the process simple. In Australia, New Zealand, and the UK loans in repayment are administered through the federal income tax system, so that income can be easily taken into account when calculating rates of repayment. That means borrowers don't have to fill out extra paperwork and overcome bureaucratic hurdles to prove they need help, like they do in the US.

For more information on loan programs in other countries, see the study, *Global Debt Patterns*, from the Educational Policy Institute at <http://educationalpolicy.org/publications.html> .

**National solutions that are “on the table” right now:**

As should be clear, reforming the federal loan programs is the best way to deal with burdensome student debt. The national programs impact millions of students each year and are a cornerstone in the nation’s federal education policy overall.

- (1) Reduce the amount students have to borrow by increasing need-based grants.
  - Increase the size of the Pell Grant and/or expand eligibility requirements. (Currently, most Pell grants go to students with family incomes below \$40,000, and the maximum grant is \$4,050.)
  - This could be paid for by cutting excessive subsidies to private lenders.
  
- (2) Protect borrowers from unregulated private loans, which have high interest rates and no protections for borrowers.
  - Increase subsidized Stafford loan limits. Currently, annual limits (detailed on the previous pages) on how much students can borrow force increasing numbers of people to cover costs by taking out private loans.
  - Punish private lenders that give students misleading information and/or charge predatory rates.
  
- (3) Make repayment fair and affordable: student loan payments should be manageable, and debt should not grow unchecked or last indefinitely.
  - Link loan repayment amounts to how much borrowers earn to help keep payments affordable. Experts say that spending more than 8% of your income on debt payments constitutes an “unmanageable” debt burden. Today almost 40% of recent graduates with student loans spend more 8% of their monthly income on loan payments.
  - Protect a certain minimum amount of income to cover basic needs, so that only borrowers who make above that amount are required to make loan payments. This would ensure that loan payments don’t push borrowers into poverty.
  - Forgive the debts of responsible borrowers after a certain number of years. Even borrowers who play by the rules often end up owing far more than they originally borrowed (usually due to accumulated interest and fees). Borrowers who have paid all they can for 10, 15, or 20 years should have an end in sight so that they can save for their futures.
  - Limit the accumulation of interest, fees, and penalties. Borrowers can end up owing two, three, or four times the amount of their original loan, due to predatory interest rate changes, fees, and penalties. There ought to be a limit on how many times over people have to pay for their loans.

- Make loan forgiveness non-taxable. Right now, most loan forgiveness is counted as income by the IRS. That means that for the few borrowers who manage to get their debts forgiven, they end up with a substantial tax bill. This goes against the principle of loan forgiveness.

**Campus-level solutions:**

There are some things that individual campuses can do to ease the burdens of debt. While these cannot affect as many students as federal policies, they can make a difference for students at schools that take these approaches.

(1) “No loan” programs: To reduce the risks of debt and attract a more economically diverse student body, a handful of schools offer grants instead of loans to students whose families make less than a certain annual income. This policy is powerful but also costly, and schools that employ it (such as Harvard, Princeton, University of Virginia, and UNC-Chapel Hill) tend to have large endowments and relatively small numbers of low-income students enrolled.

(2) Differential Packaging: If a school cannot afford to give grants to meet the full need for all low-income students, they do have some flexibility to shift the proportion of loans v. grants in the financial aid packages offered to some students. Making it possible for students without a financial safety net to borrow less can significantly reduce the risks associated with debt.

## STUDENT LOAN POLICY 101

### Background and Definitions

This document is an introduction to the main federal policies that shape the student loan programs, as well as some of the most common terminology. Understanding the current system should help generate ideas for improvement that you can pass on to the Commission.

#### Loan programs and types of loans<sup>1</sup>

The main federal loans for students are called **Stafford Loans**. Stafford Loans are either **subsidized** or **unsubsidized**. Subsidized means the government pays the interest while the borrower is in school. Unsubsidized means the borrower has to pay all the interest. The borrower can delay payment until after they are out of school, but interest has to be paid at some point. To receive a subsidized Stafford Loan, you must be able to demonstrate financial need. All students, regardless of need, are eligible for the unsubsidized Stafford Loan.

Federal loans are administered through two different programs. The benefits to students are largely the same, although there are some regulatory differences. Federal Family Education Loan Program (FFELP) loans are provided by private lenders, but the federal government makes it worth their while by reimbursing them when a borrower defaults. These are some times called “guaranteed loans” because the government (through state-run guaranty agencies) essentially insures the lenders against risk. Federal Direct Student Loan Program (FDLP) loans are made directly from the federal government to students and their parents. Most of the interest students pay on FFELP loans is kept by private lenders, whereas all of the interest paid on direct loans goes back to the federal government to help cover the costs of the program.

The government sets limits on how much students can borrow for each year of college, and over the course of undergraduate study. Dependent students can borrow less than independent students. To qualify as an independent student, you have to be at least 24 years old, married, a graduate or professional student, a parent, and/or a military veteran, or a foster child (before turning 18). A parent refusing to provide support for their child's education is not sufficient for the child to be declared independent.

#### **Undergraduate Federal Stafford Loan Limits**

	Dependent Students	Independent Students
Freshman Year	\$2,625 (\$3,500 starting July 2006 under recon.)	\$6,625 (? under recon.)
Sophomore Year	\$3,500 (\$4,500 July 2006 under recon.)	\$7,500 (? under recon.)
Junior and Senior Years	\$5,500	\$10,500
Cumulative	\$23,000	\$46,000

<sup>1</sup> Descriptions are primarily from [www.finaid.org](http://www.finaid.org), a comprehensive independent resource for information on financial aid.

In addition to Stafford loans, some campuses are able to provide Federal **Perkins Loans**. These are awarded to undergraduate and graduate students with exceptional financial need. This is a campus-based loan program, with the school acting as the lender using a limited pool of funds provided by the federal government (this program is relatively small, providing only 2% of all federal loan dollars in 2004-5). It is a subsidized loan, with a 9-month grace period (the borrower can delay payments for 9 months after graduation, and the government pays the interest during school and during the grace period), no origination or guarantee fees, and the interest rate is fixed at 5%.

**PLUS Loans** (Parent Loans for Undergraduate Students) let parents [and, starting in July 2006, graduate students] borrow money to cover any costs not already covered by the student's financial aid package, up to the full cost of attendance. PLUS loans are unsubsidized, and there is no limit on their size. Like the Stafford Loan, PLUS loans are either FFELP or Direct.

**Consolidation Loans** combine several student or parent loans into one bigger loan from a single lender. Consolidation loans are available for most federal loans, and are usually used after a student finishes college.

#### **Variable vs. Fixed Interest**

As of July 1, 2006, Stafford and PLUS loans will have a fixed interest rate of 6.8%. Previously, the interest rate was variable, which means it changed annually according to a formula tied to rates in the financial market. The benefit of a fixed rate is predictability and protection when market rates rise. The benefit of a variable rate is possibility of paying less when market rates drop.

**Default** – If a borrower fails to make payments on a loan for 270 days without making arrangements with the lender, the loan goes into default. The consequences of default are serious and often difficult to reverse. They include:

- Your loan will be turned over to a collection agency.
- Your defaulted loans will appear on your credit record, making it difficult to obtain an auto loan, mortgage, or even credit cards. A bad credit record can also harm your ability to find a job.
- You won't receive any more federal financial aid until you make arrangements to repay what you already owe and make at least six consecutive, on-time, monthly payments.
- You'll be liable for the costs associated with collecting your loan, including court costs and attorney fees, plus late fees and other costs lenders can impose.
- You'll be ineligible for deferments, forbearance, and most loan forgiveness programs.
- You can be sued for the entire amount of your loan.
- Your employer may be required to take up to 15% of your wages out of your paycheck and send the funds directly to the government.
- The federal government may take any tax refunds you are due and can withhold part of your Social Security benefit payments.
- You may not be able to get or renew a professional license.

**Bankruptcy** – It is virtually impossible to escape student loans through bankruptcy. Federal student loans have not been dischargeable through bankruptcy for a number of years; and as of October 2005, even private education loans must be paid. For both types of loans there is a provision for an exception in the case of “undue hardship.” Petitions for undue hardship are decided by a judge and very rarely granted, even to people on public assistance with high debt burdens.

**Options for relief and repayment in the current system:**

**Standard Repayment** -- Under this plan a fixed monthly amount is paid for a loan term of up to 10 years. Depending on the amount of the loan, the loan term may be shorter than 10 years. There is a \$50 minimum monthly payment.

**Graduated Repayment** -- This plan starts off with lower payments, which gradually increase every two years. The loan term is 12 to 30 years, depending on the total amount borrowed. The monthly payment must be at least the interest that accrues, and must also be at least \$25.

**Extended Repayment** -- This plan is like standard repayment, but allows a loan term of 12 to 30 years, depending on the total amount borrowed.

**Income Contingent Repayment (ICR)** – This plan, which is particularly helpful to borrowers who are having difficulty making repayments, determines the monthly payment amount based on income, family size, and amount of loan. Borrowers make payments until the loan is fully repaid with interest, up to a maximum repayment period of 25 years, after which any remaining debt is forgiven. ICR is only available under the direct loan program.

**Income Sensitive Repayment** – Lenders may allow borrowers to temporarily make smaller payments if their incomes are low. However, there is no limit on the compounding of unpaid interest, and there is no provision for loan forgiveness. New legislation makes it difficult for borrowers in FFEL who are not satisfied with ISR or other repayment options to switch to direct lending in order to get access to ICR.

**Important: Note About Repayment Terms** – While lower monthly payments spread out over a longer time may seem easier to manage, they add up to significantly higher costs in the long run. When payments are reduced, or terms are extended, it’s important to pay attention to interest costs. Ways of limiting the growth of debt during times of economic hardship include interest subsidies, caps on how much interest can accumulate under certain conditions, and loan forgiveness after a number of years of responsible repayment.

The following charts show the total costs for repayment terms of 10 and 20 years at different interest rates.

<b>Possible Repayment Schedule of a Stafford Loan of \$20,000 over 10 Years</b>				
<b>Fixed Interest Rate</b>	<b>Total \$ Amount to Pay Back</b>	<b>Total Interest as % of \$20,000</b>	<b>Total Interest</b>	<b>Monthly Payment</b>
<b>5.30%</b>	\$25,809	29%	\$5,809	\$215
<b>6.80%</b>	\$27,619	38%	\$7,619	\$230
<b>8.25%</b>	\$29,436	47%	\$9,436	\$245

<b>Possible Repayment Schedule of a Stafford Loan of \$20,000 over 20 Years</b>				
<b>Fixed Interest Rate</b>	<b>Total \$ Amount to Pay Back</b>	<b>Total Interest as % of \$20,000</b>	<b>Total Interest</b>	<b>Monthly Payment</b>
<b>5.30%</b>	\$32,478	62%	\$12,478	\$135
<b>6.80%</b>	\$36,640	83%	\$16,640	\$153
<b>8.25%</b>	\$40,900	105%	\$20,900	\$170

**NOTES:**

5.3% is the interest rate at which students in the class of 2006 will start.

6.8% will be the fixed interest rate on federal students loans scheduled for July of 2006.

8.25% is the maximum interest rate on variable-rate federal student loans.

**Interest tax deduction** – Borrowers can take an income tax deduction for up to \$2,500 of interest paid on their student loans each year. A deduction is a decrease in the amount of taxable income. (For example, if you owe taxes on \$27,500 in income and paid at least \$2,500 in interest on your student loans, after the deduction you'll owe taxes on \$25,000 in income.) People who don't earn enough to pay taxes do not benefit from a deduction.

**Deferment** – A borrower can apply to postpone loan repayment for a number of reasons. Most often, deferments are granted while a borrower is in school, and for a 6-month grace period immediately after they graduate. Other reasons include unemployment, rehabilitation from a disability, service in the military, Peace Corps, or AmeriCorps, and economic hardship. The federal government pays interest charges on subsidized loans during the deferment period. For unsubsidized loans, the borrower is responsible for the interest that accrues during deferment. Interest charges can be postponed by capitalizing the interest (adding it to the principal), which increases the size of the loan.

**Forbearance** -- During forbearance, the lender allows the borrower to temporarily postpone repaying the principal, but the interest charges continue to accrue, even on subsidized loans. The borrower must continue paying interest during the forbearance period. Forbearances are granted at the lender's discretion, usually in cases of extreme financial hardship when the borrower does not qualify for deferment. Neither forbearance nor deferment is available if a loan is in default.

**Economic Hardship** – In some circumstances, borrowers with need-based Stafford or Perkins loans can have their full interest charges paid by the government during up to

three years of unemployment or income-related economic hardship. Borrowers must document their situation, and reapply annually. Borrowers are automatically eligible if they receive public assistance. Otherwise, eligibility is based on a complex formula that's a mix of income, the federal poverty level, the amount of loan payments, and other factors.

**Loan Forgiveness --** The federal government sponsors a number of loan forgiveness programs that pay for all or part of the student loans of people who perform volunteer work or military service; or who teach or provide health care in certain types of communities. Here is a partial list of loan forgiveness programs available to different professions:

Target Group	Benefit	Length of Service Required
Elementary and High School Teachers at high-poverty schools	Total of \$5,000 (\$17,500 for math, science, and special ed only)	5 consecutive years
Child Care Providers in low-income communities	20% of Stafford loans after 2 years, up to 100% after 5 years	2 consecutive years
Registered Nurses at critical shortage facilities	If sufficient funding is available: 60% of eligible loans after 2 years, 85% after 3 years	2-year contract
Health Service Corps members in underserved communities	Up to \$50,000	2-year contract
Health Researchers	Up to \$35,000/year if debt exceeds 20% of salary.	2-year contract
AmeriCorps and VISTA Volunteers	\$4,725/year for up to 2 years	1 year of service
House and Senate Staff	Up to \$6,000/year, \$40,000 aggregate maximum	1-year contract
Federal Agency Employees (plus GAO, GPO, and Library of Congress)	Up to \$10,000/year, \$60,000 aggregate maximum	3-year contract

Other current options for loan forgiveness are: a) when a borrower has been making payments in ICR for 25 years; and b) in the case of severe and permanent disability.

For most loan forgiveness programs, the amount that's forgiven is taxed as income. (That means that if you get \$25,000 of your loan debt forgiven, you'll be taxed as if you'd earned an extra \$25,000 that year.) See this web page for a more comprehensive list of loan forgiveness programs: <http://www.finaid.org/loans/forgiven>.

## ADDITIONAL NATIONAL CHARTS

### National information on borrowing habits and income of financial aid applicants

<b>Family Income and Financial Aid 2003-2004</b>			
Undergraduate students in US	Public 4-yr	Private 4-yr	Public 2-yr
% who applied for federal aid	57%	67%	32%
% Pell grant recipients	26%	24%	19%
% of dependent undergrads with family incomes below \$60,000	30%	30%	24%

(Source: Economic Diversity database, TICAS)

<b>Federal Student Loan borrowing by institution type</b> 2003 degree recipients (no PLUS or private loans)		
Institution type	% who graduated with loans	Average debt per borrower
Two-year public	28%	\$8,365
Four-year public	58%	\$15,834
Four-year private	71%	\$17,922

(Source: National Postsecondary Student Aid Study, 2003-04  
Analyzed by Sandy Baum, College Board)

<b>Private Loans as % of Total Student Loans</b> (Graduate and Undergraduate)	
1996-97	6%
1997-98	7%
1998-99	9%
1999-00	11%
2000-01	11%
2001-02	13%
2002-03	16%
2003-04	18%
2004-05	21%

(Source: The College Board, *Trends in Student Aid, 2005*)

**TUITION AS PERCENTAGE OF REVENUE**

School Type	Total Revenue	Student Tuition and Fees	%	Federal approps	%	State approps	%	Local approps	%	Private gifts	%
4 year private grants baccalaureate	11,902,416	6,697,245	56%	578,967	5%	207,735	2%	5,661	0%	2,991,320	25%
4 year public granting baccalaureate	3,197,432	1,014,428	32%	175,190	5%	1,321,344	41%	52,231	2%	82,779	3%
4 year public granting baccalaureate AND doctorate	85,191,303	14,271,919	17%	11,596,036	14%	26,940,592	32%	250,876	0%	5,693,330	7%
2 year public granting associates	31,370,649	6,134,934	20%	1,740,726	6%	13,985,541	45%	6,136,726	20%	376,486	1%

in thousands of dollars  
from 2001 - latest available data in National Center for Education Statistics

**TUITION INCREASES**

SECTOR	TUITION AND FEES			
	2005-2006	2004-2005	\$ change	% change
2 year public	\$2,191	\$2,079	\$112	5.40%
4 year public	\$5,491	\$5,126	\$365	7.10%
4 year private	\$21,235	\$20,045	\$1,190	5.90%
SECTOR	ROOM AND BOARD			
	2005-2006	2004-2005	\$ change	% change
2 year public	*	*	*	*
4 year public	\$6,636	\$6,250	\$386	6.20%
4 year private	\$7,791	\$7,420	\$371	5.00%
SECTOR	TOTAL CHARGES			
	2005-2006	2004-2005	\$ change	% change
2 year public	*	*	*	*
4 year public	\$12,127	\$11,376	\$751	6.60%
4 year private	\$29,026	\$27,026	\$1,561	5.70%

from 2005 - Trends in College Pricing, the College Board