# 10 Models for Student-Loan Repayment

Sarah Ayres March 22, 2013

As more students are struggling to pay back their student loans after graduation, it is now more important than ever for borrowers to have access to a student-loan-repayment plan that eases the burden of repayment and minimizes the risk of default. Students today face staggeringly high tuition bills, a youth unemployment rate of 12.5 percent, and a complicated assortment of student-loan-repayment plans that can be difficult to navigate even for the borrowers lucky enough to find well-paying employment. Recognizing these obstacles, President Barack Obama and Congress have expanded student-loan repayment options, and advocates have proposed various plans to make it easier for borrowers to pay back school debt. Even with these advances, however, it is clear that existing student-loan-repayment options aren't working for many borrowers.

Borrowers of federal student loans are finding it increasingly difficult to make timely payments on their debt. With $864 billion in federal loans and $150 billion in private loans, student debt in America now exceeds $1 trillion.[1] More than 13 percent of students whose loans came due in 2009 were in default on their debt as of September 2012, meaning that they hadn't made a payment in at least nine months.[2] What's more, another 26 percent of borrowers were delinquent on their loans, meaning that they missed payments on their loans for more than 60 days.[3] Borrowers who fall behind on their student-loan payments can face poor credit ratings and wage garnishment, and the federal government incurs additional costs as it attempts to recover the loans.

The Higher Education Act—which authorizes federal student-aid programs for postsecondary education and is up for reauthorization in 2013—provides an opportunity for policymakers to redesign the student-loan-repayment system. As Congress considers possible changes, it is important for everyone to understand the various options.

Everyone can agree that making it easier for students to pay back their loans will benefit both borrowers and federal balance sheets, and there are a number of existing and proposed plans designed to achieve this objective. As lawmakers evaluate the options, they should keep in mind that any student-loan-repayment system should be designed

to provide a safety net to the low-income borrowers who need it most, to minimize defaults, and to be accessible and easy for students to use.

This issue brief will outline the parameters of 10 different student-loan-repayment plans, highlight the benefits of each, and suggest issues for policymakers to take into account when considering each plan.

## 10 student-loan-repayment plans

### Existing repayment plans

#### *Standard 10-Year Repayment Plan*

The Standard 10-Year Repayment Plan is a plan that is currently available to all borrowers of federal student loans.[4] Under the plan, the borrower fully repays the loan with interest by making the same fixed monthly payment every month for 10 years.

A borrower with a starting balance of $25,000 at 6.8 percent interest, for example, would make 120 payments of $287.70 each, for a total of $34,524.10.

The advantages of the Standard Repayment Plan are that borrowers will pay off their loans sooner—compared to most other repayment plans—and end up paying the least interest overall. The disadvantage of this plan, however, is that borrowers who start their careers with a low income may find making payments in the early years to be difficult or even impossible.

#### *Graduated Repayment Plan*

The Graduated Repayment Plan is also currently available to all borrowers of federal student loans.[5] Under the plan, the borrower fully repays the loan with interest by making monthly payments that increase in time for 10 years.

The same borrower with a starting balance of $25,000 at 6.8 percent interest, for example, would make 120 monthly payments that start at $197.54 in the first two years of repayment and increase every two years until they reach $431.55 in the last year of repayment, for a total of $36,388.89.

The advantages of the Graduated Repayment Plan are that borrowers will still pay their loans off sooner than is the case with most other plans and are able to make lower monthly payments in the first years of employment, when their incomes are likely to be lowest. The disadvantages of the plan, however, are that borrowers will end up paying more interest than they would if they repay according to the Standard 10-Year Repayment Plan; borrowers who start off with a very low income may still find that the

early payments are difficult or impossible to make; and borrowers must make payments in later years that are substantially higher than they would have been under the Standard 10-Year Repayment Plan.

### *Extended Repayment Plan*

The Extended Repayment Plan is currently available to borrowers of federal student loans who have a starting balance of more than $30,000.[6] Under the plan, the borrower fully repays the loan with interest by making either fixed or graduated monthly payments for up to 25 years.

A borrower with a starting balance of $45,000 at 6.8 percent interest, for example, could make 300 payments of $312.33 each, for a total of $93,699.73. Alternatively, he or she could make 300 graduated payments—starting at $258.93 in the first two years of repayment and ultimately reaching $435.36 in the last year of repayment—for a total of $100,910.03.

The advantage of the Extended Repayment Plan is that borrowers with more debt are able to make lower, more affordable payments by extending the length of the repayment period. The disadvantages of the plan, however, are that borrowers will pay more interest overall and borrowers who start off with a very low income may still find that the early payments are difficult or impossible to make.

### *Income-based repayment*

Borrowers who took out loans before 2008 are eligible for income-based repayment, in which they may make monthly payments based on 15 percent of their discretionary incomes if they face financial hardship.[7] Under income-based repayment, a borrower makes monthly payments equal to 15 percent of his or her income above 150 percent of the poverty line and any unpaid principal or interest is forgiven after 25 years. Under the plan, the minimum monthly payment may never be greater than what the borrower would have paid under the Standard 10-Year Repayment Plan. Under income-based repayment, borrowers employed full time in public service may qualify for loan forgiveness after 10 years.

A borrower with a starting balance of $25,000 at 6.8 percent interest, for example, would make monthly payments of $38 in his or her first year of repayment when his or her income is $22,000. Years later, when the borrower's income increases to $70,000, he or she would only have to make minimum monthly payments of $289—the same amount he or she would have paid under the Standard 10-Year Repayment Plan.

The advantages of income-based repayment are that borrowers will have manageable payments when their incomes are low and loan forgiveness after 25 years of payments. The disadvantages of income-based repayment, however, are that borrowers will accrue more interest than they would if repay according to the Standard 10-Year Repayment Plan; they must submit annual documentation of income and family size to demonstrate eligibility; and they will have to pay taxes on any loan forgiveness that occurs after 25 years.

### *Pay as You Earn*

Borrowers who took out loans after 2008 are eligible for Pay as You Earn, in which they may make monthly payments based on 10 percent of their discretionary incomes if they face financial hardship.[8] Under Pay as You Earn, a borrower makes monthly payments equal to 10 percent of his or her income above 150 percent of the poverty line and any unpaid balance is forgiven after 20 years. As with income-based repayment, the minimum monthly payment may never be greater than what the borrower would have paid under the Standard 10-Year Repayment Plan. Also as with income-based repayment, borrowers employed full time in public service may qualify for loan forgiveness after 10 years.

Under Pay as You Earn, the borrower in the earlier example with a starting balance of $25,000 at 6.8 percent interest would make monthly payments of $25 in his or her first year of repayment when his or her income is $22,000. Even when the borrower's income grows to $60,000, he or she would only have to make monthly payments of $284, less than the amount he or she would have paid under the Standard 10-Year Repayment Plan.

The advantages of Pay as You Earn are that a borrower will have low monthly payments when his or her income is low, although the payments for low-income borrowers are not significantly less than they would be under income-based repayment—$25 instead of $38 in the above example. The borrower also has the opportunity for forgiveness after just 20 years.

The disadvantages of Pay as You Earn, however, are that borrowers must submit annual documentation of income and family size to demonstrate eligibility and will have to pay taxes on any loan forgiveness that occurs after 20 years. As analysts at the New America Foundation have suggested, the biggest beneficiaries of the program might be high-income, high-debt borrowers who receive substantial loan forgiveness after 20 years.[9]

### *Consolidation*

Consolidation is currently available to borrowers who have multiple loans and would like to combine them into a single loan. Under consolidation, the newly combined loan carries a fixed interest rate based on the weighted average of the interest rates of the underlying loans rounded to the nearest higher one-eighth of a percent and not exceeding 8.25 percent.[10] A borrower with $15,000 in unsubsidized federal Stafford loans at 6.8 percent and $20,000 in federal direct PLUS graduate loans at 7.9 percent, for example, would be able to consolidate his or her loans into one $35,000 consolidation loan at 7.5 percent.

After consolidating, a borrower repays the loan by making payments that are fixed, graduated, or income-based for up to 30 years, with the length of the repayment period depending on the size of the loan. Under the Standard 10-Year Repayment Plan, for instance, the borrower in our example would make payments of $281.96 per month, for a total of $67,669.83.

The main advantage of consolidation is that a borrower can combine his or her multiple loans into a single loan with a single monthly payment. The disadvantage of consolidation, however, is that a borrower will pay more interest overall by extending the length of the repayment period.

## Options for repayment reform

### *New America Foundation plan*

Under the New America Foundation's new proposal to reform federal student aid, all borrowers would repay their loans based on a percentage of their incomes.[11] A borrower whose income is less than 300 percent of the poverty line would make minimum monthly payments of 10 percent of his or her income above 150 percent of the poverty line. A borrower whose income is greater than 300 percent of the poverty line would make minimum monthly payments of 15 percent of his or her income. Unlike both income-based repayment and Pay as You Earn, there is no upper limit on the minimum payment amount—a borrower must always make payments equaling 15 percent of his or her discretionary income.

Under the New America Foundation plan, student-loan interest rates are set at the 10-Year Treasury rate plus 3 percent. Under that formula, the rate on loans taken out in the 2012–13 academic year would be 4.9 percent. Borrowers with an initial loan balance of less than $40,000 would have any unpaid debt forgiven after 20 years, and borrowers with an initial loan balance of more than $40,000 would have any unpaid debt forgiven after 25 years. Unlike the current system, the New America Foundation plan would eliminate taxes on loan amounts that are forgiven.

The advantages of the New America Foundation plan are that borrowers will have low monthly payments when their incomes are low, loan forgiveness after either 20 or 25 years, and will not have to pay taxes on debt forgiveness. Furthermore, the plan targets federal dollars toward the low-income borrowers who need the most help. A possible disadvantage of the plan, however, is that students who take out loans when Treasury rates are high will face significantly higher interest rates on their loans.

### *Australian model*

Under Australia's current student-loan repayment plan, all borrowers repay a percentage of their incomes through payroll withholding. When a borrower reaches a minimum income threshold equivalent to about U.S. $50,000, a payment of 4 percent to 8 percent of income is collected through routine payroll deduction.[12] Instead of charging interest, all loans are assessed a set fee of 25 percent of the initial balance of the loan, and the balance of the loan is then adjusted annually for inflation.[13]

The advantages of the Australian model are that borrowers have either low or no payments when their incomes are low, never pay more than 8 percent of their incomes, and do not have to worry about paying more in interest if they take longer to repay their loans. Furthermore, borrowers do not have to choose between multiple repayment plans, set up monthly payments, or document their income in order to qualify for low or no payments.

A disadvantage of the Australian model, however, is that—because repayment occurs through tax collection—graduates who leave the country do not pay back their loans. According to a recent report by Australia's Grattan Institute, an estimated 20 percent of Australian student-loan debt will never be paid off due to borrowers either earning too little or moving out of the country.[14]

### *Petri Bill (ExCEL Act)*

Under legislation proposed late last year by Rep. Tom Petri (R-WI), all student-loan borrowers would repay 15 percent of their discretionary incomes through payroll withholding.[15] The bill would combine all federal loans into one loan with a fixed interest rate based on the 10-year Treasury rate plus 3 percentage points for loans up to $31,000 and 4.1 percentage points for loans exceeding $31,000. A borrower would repay 15 percent of his or her income above 150 percent of the poverty line through routine payroll deduction.[16] Unlike with current repayment options, interest accrued during repayment would not compound, and interest would stop accruing when the total amount of interest accrued equals 50 percent of the loan's original balance. Under the plan, there is no loan forgiveness for public service.

A borrower with a starting balance of $40,000, for example, would make monthly payments of $103 when his or her income is $25,000. Later, when his or her income increases to $75,000, he or she would make minimum monthly payments of $728.[17]

The advantages of the Petri model are that borrowers have either low or no payments when their incomes are low and can only accrue a limited amount of interest. Moreover, they do not have to choose between multiple repayment plans, set up monthly payments, or document their income in order to qualify for low or no payments.

Additional issues to consider with this model involve the interest-rate calculation, the treatment of loans held by public servants, and the lack of deferment or forbearance. While 10-year Treasury rates have recently been as low as 1.9 percent, rates were as high as 15 percent in the 1980s.[18] Under the Petri formula, this would result in student-loan interest rates ranging from 4.9 percent to 18 percent. The cap on accrued interest, however, may offer some protection to borrowers from extremely high interest rates. The Petri bill also eliminates loan forgiveness for public service and the option for deferment or forbearance that is currently available to borrowers in other plans under special circumstances such as economic hardship.

### *Lumni model*

Lumni is a social enterprise that provides loans to students who agree to pay back a set percentage of their incomes to the lender after graduation. Under the Lumni model, the borrower typically agrees to pay between 4 percent and 8 percent of his or her first 10 years of income, with the percentage depending on the size of the loan and the borrower characteristics. The loan does not accrue interest, and the borrower may end up paying back more or less than the original amount of the loan depending on his or her income over 10 years.[19]

In one example provided by Lumni, a nursing student in Colombia borrowed $8,530 from Lumni in exchange for agreeing to repay 14 percent of his salary for 118 months.[20] If he makes the expected salary for a nurse, he will end up paying the equivalent of a 17 percent interest rate.[21] If he is unable to find employment for a portion of that time, however, he might only repay the balance of the loan—or repay even less, if his eventual earnings are low.

An advantage of the Lumni model for students is that a borrower who struggles to find work or ends up in a low-paying career will never have to pay more than a certain percentage of his or her salary. A disadvantage, however, is that high-income borrowers may end up paying the equivalent of extremely high interest rates. One issue to consider is how Lumni determines payments—is there a poverty exemption, for example, or is there a salary below which borrowers do not make repayments?

## Conclusion

Rising student debt and high default rates on student loans indicate that the safety net for student-loan borrowers is insufficient. This brief outlines 10 commonly discussed models for student-loan repayment, ranging from existing repayment plans to foreign models to proposed legislation. Key principles for student-loan repayment are that the system should:

- Provide a safety net for borrowers who need it
- Minimize defaults and delinquencies
- Be easy to use

Easing the burden of repayment is only one piece of the puzzle when it comes to fixing America's student-debt crisis. Reforms must also address the rapidly increasing cost of college, the rise of for-profit colleges offering worthless credentials, expensive private student loans, the inability of borrowers to refinance their student loans at lower interest rates, and the restriction against discharging student loans in bankruptcy. As part of these broader reforms, lawmakers should place a priority on creating a student-loan repayment system that provides an adequate safety net for borrowers.

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## Endnotes


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