

Testimony of Jason Delisle
Director, Federal Education Budget Project
New America Foundation

U.S. House of Representatives Committee on Education and the Workforce

"Keeping College Within Reach: Examining Opportunities to Strengthen Federal Student Loan Programs"

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Chairman Kline, Ranking Member Miller, and committee members, thank you for inviting me to testify about the need to improve the federal student loan program.

My colleagues in the New America Foundation's Education Policy Program and I have developed a set of recommendations that we believe will improve the federal student loan programs to the benefit of students and taxpayers. These recommendations were first published in two New America Foundation papers, *Safety Net or Windfall? Examining Changes to Income-Based Repayment for Federal Student Loans* (October 2012) and *Rebalancing Resources and Incentives in Federal Student Aid* (January 2013). Those recommendations are discussed briefly below.

At the end of this testimony is a brief explanation of the series of events that led Congress to enact the current interest rate structure on federal student loans. That information may be helpful to the Committee as it considers changes to student loan interest rates.

The Case for Reforming Federal Student Loans

- The federal student loan program is extremely complex, offering students and their families a variety of choices, with each carrying different congressionally set interest rates and borrowing limits. Borrowers also face a baffling array of repayment options. Benefits often overlap, which lead to unintended interactive effects.
- Graduate students and the parents of undergraduates can take out loans up to the full cost of attendance. This encourages and enables imprudent borrowing, and also makes it easier for colleges and universities to raise their prices with impunity.

- The benefits of the loan program are poorly targeted. The programs provide generous federal subsidies to some students based on their incomes before they enroll in school, rather than after they graduate, which is when they actually pay their loans back. Students are also charged the same interest rates regardless of changes in market interest rates, such that students are provided different levels of subsidies from year to year for no particular reason. Recent changes to the Income-Based Repayment plan provide the largest benefits to those who borrow most, particularly graduate students, even if they earn a high income.
- The program does not provide enough incentives for students to make steady progress and complete a credential on time. In some cases, it does the opposite.

Recommended Reforms

Address Flaws in the IBR Program and Make it the Sole Repayment Option for Borrowers

A simpler federal loan program with better targeted benefits should offer a single repayment plan that is similar to both the *Pay-As-You-Earn* plan that the U.S. Department of Education recently enacted (which itself is meant to mimic a plan in statute set to take effect in 2014 and is referenced throughout this testimony as “new IBR”) and the Income-Based Repayment plan that was enacted in 2007 (referenced throughout this testimony as “old IBR”).¹ This sole repayment plan must incorporate changes to the current system to ensure that it does not provide windfall benefits to higher income borrowers who have the means to repay their debt or indemnify high tuitions and over-borrowing. Those recommended changes are the following:

- **Recommendation #1:** Maintain the lower payment calculation (10 percent of AGI) in New IBR, but only for borrowers with AGIs at or below 300 percent of the federal poverty guidelines (\$33,510 for a household size of one). Borrowers with AGIs above 300 percent will pay according to the Old IBR formula (15 percent of AGI).

Justification: This change targets the benefits of lower monthly payments under New IBR to lower-income borrowers only. Borrowers earning more, while still eligible for IBR, must make payments based on the Old IBR formula. Additionally, by requiring borrowers with incomes above 300 percent of the federal poverty guidelines to make monthly payments based on 15 percent of their AGIs, it is much less likely that high-income borrowers will receive loan forgiveness. It also allows borrowers with lower incomes to benefit from the 10 percent rate that New IBR offers, but ensures that they will repay those benefits by paying at a higher rate if their incomes increase later.

Lastly, those borrowers with AGIs above 300 percent of the poverty guidelines will likely have total incomes that are markedly higher than their AGIs because they are able to make pre-tax benefit payments, contribute to retirement savings, and take larger above-the-line deductions. Imposing a higher payment calculation (15 percent of AGI) on these borrowers compensates for their significantly lower AGIs relative to their total salaries.

- Recommendation #2: Maintain the loan forgiveness threshold from New IBR (20 years), but only for borrowers whose loan balances when they entered repayment do not exceed \$40,000. Borrowers with higher initial balances would qualify for loan forgiveness after 25 years of repayment, the same as under Old IBR.

Justification: Like the first recommendation, this proposal would maintain the more generous benefits of New IBR, but not for all borrowers. A two-tiered loan forgiveness system based on initial debt levels would keep the 20-year loan forgiveness targeted toward borrowers who have debt from undergraduate studies or moderate amounts of debt from graduate studies and who struggle to repay. By creating a longer loan forgiveness threshold for borrowers with debt levels above \$40,000, this recommendation also reduces the tendency that New IBR has to provide loan forgiveness to high-income, high-debt borrowers when they are most able to make higher payments on their loans for a total of 25 years. This two-tiered approach would discourage graduate and professional schools that charge high tuitions and their students who borrow federal loans from using IBR as an indemnification tool.

- Recommendation #3: Eliminate the maximum payment cap. Borrowers must always pay based on the IBR income formulas, no matter how high their incomes are. Additionally, borrowers may not opt to enroll in another repayment plan.²

Justification: The maximum payment cap targets IBR benefits to higher-income borrowers either by reducing their monthly payments, increasing the amount of loan forgiveness they receive, or both. It can also increase the chances that a borrower earning a very high income (over \$200,000) would qualify for loan forgiveness. Lastly, requiring that borrowers stay in IBR for the duration of their repayment term will ensure that borrowers who benefited from IBR when their incomes were low will pay commensurately higher payments should their incomes increase—this helps offset some of the initial costs the government incurred when the borrowers benefitted from low payments while their incomes were lower.

- Recommendation #4: The U.S. Department of Education and policymakers should be forthcoming about the negative consequences borrowers may face when repaying through IBR. The Department should provide borrowers with illustrative examples of how paying off their loans more slowly could increase what they pay and provide clear warnings. Private companies servicing federal student loans should clearly indicate to borrowers how much interest accrues on their loans when they repay through IBR and how that is likely to increase the repayment term and total interest costs they will pay.

Justification: IBR entails some financial risks for borrowers (those risks exist for Old IBR, though New IBR entails far less financial risk for borrowers with debt levels that exceed \$20,000). Borrowers may save little per month under IBR and end up paying more and for longer due to the added interest costs. Borrowers do make a trade-off in paying a minimum monthly payment under IBR over electing to make pre-payments, and loan servicers and

the U.S. Department of Education should ensure that borrowers are informed of those trade-offs.

- Recommendation #5: IBR payments for a borrower who is married but files a separate income tax return should be based on the household's combined AGI. The program currently allows borrowers to file separate income tax returns and use only the borrower's income to calculate payments under IBR. This policy should include an exception for cases where both spouses are making payments on federal student loans under IBR. In that case, each borrower's loan payments should be based on one-half of household income.

Justification: Married borrowers with low individual, but high household incomes can still qualify for IBR (including loan forgiveness) by filing a separate income tax return. If these borrowers also have children, they can significantly increase the benefits they earn under IBR by designating the children as dependents on their annual IBR application since it increases their household size and the poverty exemption they receive under IBR. This provision is another way in which higher-income borrowers (based on household income) can qualify for generous benefits under IBR. Ending this provision will ensure that the program's benefits are targeted to borrowers who need the most assistance. The exception for couples in which each spouse is repaying a federal student loan will ensure that borrowers in a two-borrower household do not each have to make payments on their loans on their combined incomes—which would essentially be double-counting their incomes.

- Recommendation #6: Make loan forgiveness tax-free using budgetary savings that arise from the other recommendations outlined above.

Justification: Federal tax law treats loan forgiveness under IBR (except when provided for public service employees) as taxable income. Borrowers who receive loan forgiveness (under an IBR that reflects the recommendations outlined here) will likely have experienced some degree of financial hardship. Therefore, they are also likely to struggle with what could be a relatively large tax bill in the year they receive loan forgiveness. If IBR is meant to aid this type of borrower, then it should not impose its own type of financial burden on them.

- Recommendation #7: Allow *all* current borrowers to enroll in an IBR that reflects these recommendations. Do not limit it to new borrowers and new loans.

Justification: Old IBR is available to all borrowers, but Congress and the Obama administration have limited access to New IBR to more recent borrowers to reduce the cost of the program. The recommendations outlined above would preserve some of the benefits of New IBR, but target them to those borrowers with more financial need, thereby reducing the cost. The recommendations would further reduce costs by limiting benefits to higher-income borrowers compared to even Old IBR. Therefore, policymakers could open the program to all borrowers at little or no incremental cost to taxpayers, and a greater number of borrowers would gain access to lower repayments and earlier loan forgiveness.

- **Recommendation #8:** Ensure that loan servicers have the requisite income information from borrowers when they begin repaying their loans. Require borrowers to agree in their promissory notes to allow their loan servicers and the U.S. Department of Education to access necessary information from their most recent federal income tax return.

Justification: The main impediment to making IBR the automatic and only repayment plan for all new borrowers is that borrowers must first submit information to loan servicers before their monthly payment can be calculated and billed. Requiring that borrowers authorize the U.S. Department of Education to access the necessary information from their tax returns upon signing a promissory note for a federal student loan will ensure that the loan servicer can calculate a borrower's payment without the borrower having to first submit information.

Repayment Tables for Two Borrowers Under Different Repayment Plans

The tables below are excerpted from *Safety Net or Windfall? Examining Changes to Income-Based Repayment for Federal Student Loans*.³

Figures for the recommended IBR changes reflect all proposed changes listed in this testimony except that borrower income does not reflect household income. All borrowers file separate federal income tax returns and designate any children that they have as dependents. The interest rate for all repayment plans is the rate the borrower would pay under the consolidation plan, which is the weighted average rate rounded to the nearest one-eighth of one percent.

Graduate A: Starting Balance: \$78,393 at 7.000%

Repayment Year	1	3	5	10	15	20	25	30	Total	Forgiven
Salary (\$)	45,000	48,431	65,000	110,000	175,000	197,996	224,015	253,452	Payments	
IBR Old (\$)										
Monthly payment	297	325	500	720	910	910	-	-	176,460	-
Loan Balance	80,122	83,063	84,044	81,513	59,545	20,702	-	-		
IBR New (\$)										
Monthly payment	198	217	333	480	910	910	-	-	124,193	65,407
Loan balance	81,188	86,434	90,746	98,025	91,419	65,407	-	-		
IBR Recommended (\$)										
Monthly payment	297	325	500	720	1,570	-	-	-	164,585	-
Loan balance	80,122	83,063	84,044	81,513	51,631	-	-	-		
Consolidation (\$)										
Monthly payment fixed	522	522	522	522	522	522	522	522	187,758	-
Monthly payment graduated	459	474	483	514	558	591	642	741		

Source: New America Foundation. Note: Loan balance reflects principal and accrued unpaid interest at the end of the repayment year indicated. Borrower has a child in each of years six and 10, included in calculation thereafter. Borrower has \$8,000 in Subsidized Stafford loans from undergraduate studies.

Graduate C: Starting Balance: \$41,570 at 6.875%

Repayment Year	1	3	5	10	15	20	25	30	Total	Forgiven
Salary (\$)	28,000	39,000	41,375	48,000	65,000	80,000	97,332	118,420	Payments	
IBR Old (\$)										
Monthly payment	106	219	152	185	329	444	480	-	84,582	28,633
Loan Balance	42,855	44,303	46,442	50,467	51,383	42,157	25,869	-		
IBR New (\$)										
Monthly payment	70	146	101	123	219	296	-	-	37,280	60,465
Loan balance	43,196	45,700	49,031	56,478	61,851	60,465	-	-		
IBR Recommended (\$)										
Monthly payment	70	146	101	123	219	296	578	-	68,615	46,916
Loan balance	43,196	45,700	49,031	56,478	61,851	60,465	46,916	-		
Consolidation (\$)										
Monthly payment fixed	291	291	291	291	291	291	291	-	87,150	-
Monthly payment graduated	241	252	263	288	328	363	446	-		

Source: New America Foundation. Note: Loan balance reflects principal and accrued unpaid interest at the end of the repayment year indicated. Borrower has one child in year four who is included in calculation thereafter. Loan balance includes \$8,000 in Subsidized Stafford loans from undergraduate studies.

Graduate D: Starting Balance: \$165,882 at 7.375%

Repayment Year	1	3	5	10	15	20	25	30	Total Payments	Forgiven
Salary (\$)	90,000	93,600	101,238	135,000	164,248	243,360	249,505	255,805		
IBR Old (\$)										
Monthly payment	747	774	844	1,248	1,442	1,958	1,958	-	409,445	23,892
Loan Balance	169,154	175,430	180,061	184,231	164,920	112,129	23,892	-		
IBR New (\$)										
Monthly payment	498	516	563	832	961	1,603	-	-	202,299	208,259
Loan balance	172,141	184,481	195,724	218,894	226,410	208,259	-	-		
IBR Recommended (\$)										
Monthly payment	747	774	844	1,248	1,442	2,405	2,309	-	423,507	-
Loan balance	169,154	175,430	180,061	184,231	164,920	100,022	-	-		
Consolidation (\$)										
Monthly payment fixed	1,146	1,146	1,146	1,146	1,146	1,146	1,146	1,146	412,454	-
Monthly payment graduated	1,008	1,042	1,063	1,133	1,232	1,304	1,420	1,647	448,656	-

Source: New America Foundation. Note: Loan balance reflects principal and accrued unpaid interest at the end of the repayment year indicated. Borrower has a child in each of years eight and 12, included in calculation thereafter.

End the Subsidized Stafford Interest Rate Benefit

Since the passage of the Higher Education Amendments of 1992, all undergraduate borrowers have been able to take out federal Stafford loans regardless of income or other need-based tests, at terms that have been generally more favorable than those in the private market.⁴ Prior to the enactment of that policy, the federal loan program allowed only financially needy students to borrow.⁵ These loans had always included an interest-free benefit under which the loan would not accrue interest while the borrower was in school. However, when policymakers opened up the federal student loan program to borrowers of all income backgrounds in 1992, they maintained the interest-free benefit for borrowers who met a needs analysis test that accounted for the cost of attendance at students' institutions, but did not provide a similar benefit for other borrowers. That interest-free benefit remains the distinction between the two loan types that still exist in today's program: Subsidized Stafford loans and Unsubsidized Stafford loans.

In other words, Subsidized Stafford loans were not created to provide benefits over and above those on Unsubsidized Stafford loans. Rather, it is a benefit that was always provided as part of the federal student loan program. The Subsidized and Unsubsidized Stafford loan distinction remains current policy mainly due to historical circumstances. That fact is made clearer by some of the policy's shortcomings and how it interacts with the myriad changes policymakers have made to the student loan programs in recent years.

In fact, Subsidized Stafford loans do not always provide the greatest benefits to the lowest-

income students. Subsidized Stafford loans are awarded to borrowers in part according to the cost of attendance of their schools. That means a borrower with a high-family income will be eligible for the loans if he attends the most expensive type of institution, while a similarly situated borrower who opts to attend a low-cost institution will qualify only for Unsubsidized Stafford loans. This is why, in spite of income and assets tests targeting the aid to lower income families, 12 percent of borrowers who receive Subsidized Stafford loans come from families earning over \$100,000 per year.⁶⁰

Furthermore, the Income-Based Repayment Plan better aligns repayment with a borrower's ability to repay, whereas Subsidized Stafford loans are provided to borrowers based largely on their family income when they enter school. For example, borrowers with Unsubsidized Stafford loans begin repayment with higher loan balances than students with Subsidized Stafford loans (assuming everything else is equal) because interest has accrued on the loan. Under IBR, the higher loan balance does not necessarily mean the borrower will pay more than if he had a lower loan balance – monthly payments are based on a borrower's income, not loan balance. Therefore a borrower who earns a persistently low income over his repayment term would make the same payments regardless of the size of his initial loan balance. Only borrowers with higher incomes in repayment stand to gain from Subsidized Stafford loans.⁶

The Obama administration recommended in 2011 that graduate students be eliminated from the Subsidized Stafford program going forward, and Congress acted on that policy, redirecting the budgetary resources to the Pell Grant program. The administration noted that, in addition to the Income-Based Repayment option available to graduate and professional students, "eligibility for the interest subsidy is based on 'ability-to-pay' at the time of enrollment, but the borrower realizes the benefit later – typically years later – in the form of lower loan payments after leaving school."⁷ The administration also argued that government aid should be targeted to the highest-need students.⁸ All of those arguments apply to the case for eliminating the Subsidized Stafford loan interest-free benefit for undergraduate students, particularly if IBR is the only repayment option for borrowers.

Create a Fixed Formula for Setting Student Loan Interest Rates

Interest rates on federal student loans are arbitrary and inflexible because Congress set the rates as nominal figures in law based on what would have been a subsidized interest rate in the year 2001.⁹ They are not based on any formula, nor do they bear any relation to changes in related interest rates in the market since then. The rate on all newly-issued Unsubsidized Stafford loans as of 2006 is 6.8 percent, and under current law will remain so in perpetuity.

The effect of such a policy is to provide very different levels of subsidies to borrowers depending on when they take out their loans. The subsidy on loans issued at the 6.8 percent interest rate in 2007 when the economy was booming and interest rates were relatively high was much larger than the subsidy provided to students in today's low-interest rate, slow-growth economy. That means students receive larger subsidies when they are least needed; the policy is both inefficient and unfair. In fact, the Congressional Budget Office estimates that the loans issued in fiscal year 2013 will not provide any subsidies (meaning the terms provide no value

over loans in the private market) to the vast majority of borrowers.¹⁰ This will be the first time that federal student loans provide no subsidy, based on fair-value estimates.

A better policy would be to set interest rates on all newly-issued federal student loans at 3.0 percent, plus a markup equal to long-term U.S. Treasury borrowing rates. The fixed rate of 3.0 percent would ensure that the government partially covers the costs of making the loans (i.e. administrative costs and costs associated with defaults, collections, and delinquencies), and the markup would allow the loan rates to adjust based on long-term interest rates. The interest rates charged to borrowers would still be fixed for the life of the loan, but the rate for new loans would change each year based on the market rates for 10-year Treasury notes.

Under that formula, the interest rate for federal loans issued for the 2012-13 school year would be about 4.9 percent, a big drop from the 6.8 percent rate that is currently charged on Unsubsidized Stafford loans. That rate would be available on all newly issued Stafford loans to undergraduate and graduate borrowers.

Because the rate offered on newly-issued loans would adjust annually, it could be higher in future years. However, Income-Based Repayment on federal student loans, coupled with loan forgiveness after 20 or 25 years in repayment, ensures that the rate a borrower pays cannot rise to unaffordable levels regardless of the loan's nominal rate. It also ensures that borrowers earning higher incomes, those who are most able to pay, are the only ones who could face higher interest rates under the policy. Income-Based Repayment is effectively an income-based interest rate cap that provides benefits to borrowers based on need, but it determines the cap in repayment, rather than at the time of enrollment.

How IBR Works as an Interest Rate Cap

The following scenarios were developed using the New America Foundation IBR calculator.¹¹

Consider someone with \$45,000 in debt from undergraduate and graduate studies who works in the government/non-profit sector and earns a starting salary of \$38,000 (AGI of \$34,200) with a four percent annual raise. At an interest rate of 4.9 percent, she pays a total of \$22,281 on her loans over 10 years, and then the remaining balance is forgiven under Public Service Loan Forgiveness. At an interest rate of 12 percent she still pays \$22,281 and the remaining balance is forgiven. Even if her interest rate were 0.0 percent, her total payments would still be \$22,281.

What if the same person worked in the for-profit sector and therefore qualifies for loan forgiveness after 20 years of payments instead of 10? At an interest rate of 4.9 percent, her total payments over 20 years are \$58,998, and she has some remaining debt forgiven. Increase her interest rate to 12 percent and her total payments are still \$58,998. IBR has capped her payments – and the interest rate on her loan – because her income is not high enough for the interest rate to matter.

As another example, consider a borrower with undergraduate debt of \$28,000, who works in the for-profit sector, with a starting income of \$29,000 (AGI of \$26,100) and an annual increase of three percent. She would pay \$27,228 on her loans over 20 years at an interest rate of 2 percent, 5 percent, or 25 percent. Her monthly payments over that time would be no higher or lower under any of those interest rates.

Under IBR, only borrowers with higher incomes would be affected by higher interest rates. But the program still provides a cap even for these borrowers, albeit a higher cap. Moreover, monthly payments are still based on income; only the length of payment is affected by the interest rate. And high-income borrowers who work for the government or non-profit organizations fare even better, because they qualify for 10-year loan forgiveness.

Imagine a borrower with \$40,000 in debt and a starting salary of \$50,000 (AGI \$45,000), who receives an annual raise of four percent. If she works for a non-profit employer, the interest rate on her loan is irrelevant. She will pay \$35,247 before her remaining debt is forgiven (after 10 years of payments) whether the interest rate is 2 percent, 6 percent or 12 percent. However, if she works for a for-profit employer, her higher income means she will pay for longer if the interest rate is higher. But if the rate is 8 percent or higher, she won't pay all of the extra costs. Instead, she will have much of it forgiven once she reaches 20 years of payments.

Set One Loan Limit for All Undergraduates, Irrespective of Their Dependency Status

Policymakers should simplify the federal loan program by eliminating the distinction between dependent and independent undergraduates and allowing both types of students to borrow the same amount of loans. Under the New America Foundation proposal, the annual limits for all undergraduates would be \$6,000 for a first year student, \$7,000 for a second-year student, and \$9,000 for a third-, fourth-, or fifth -year student. The aggregate limit for undergraduates would be \$40,000.

These proposed limits are higher than dependent undergraduates can currently borrow on their own but less than independent undergraduates can take out. This increase is appropriate due to our proposed elimination of Parent PLUS loans, which is outlined later in this document, and the fact that current loan limits for independent students can lead to excessive amounts of debt. As of now, an independent undergraduate student who borrows the maximum in federal loans would begin repayment with a principal and interest balance of approximately \$74,000, an amount that would require \$486 monthly payments over 30 years to repay under the currently available repayment plans.

End Grad PLUS, but Increase Stafford Loan Limits for Graduate Students

Policymakers should end the Grad PLUS loan program. This program allows graduate and professional students to borrow up to the full cost of attendance at an institution of higher education, with no time or aggregate limit. Such a policy, especially when coupled with loan forgiveness and Income-Based Repayment, can discourage prudent pricing on the part of institutions and prudent borrowing by students. However, policymakers should increase the annual limit on Unsubsidized Stafford loans for graduate students from the current \$20,500 to

\$25,500 to replace some of the borrowing ability graduate students will lose when the Grad PLUS loan program is eliminated.

If institutions can no longer rely on PLUS loans to fund their high-tuition programs and if the private market is responsive to the ability of borrowers to repay, then graduate schools may have to set their pricing based, in part, on students' expected earnings. Since those in graduate school already have an undergraduate degree and are preparing for a profession, it is more reasonable to expect that loans above the Stafford limits be based on prospective ability to repay. Underwriters will likely focus most intently on institutional characteristics to determine risk. Consequently, programs that poorly prepare students to repay their debts will find that their students cannot access much credit in the private market, which should change institutional behavior in terms of quality and pricing.

End Parent PLUS Loans

In addition to ending the Grad PLUS loan program, policymakers should eliminate the Parent PLUS loan program. As the cost of attending college has soared, so too have Parent PLUS loan disbursements. According to a recent article in *The Chronicle of Higher Education*, the government issued \$10.6 billion of Parent PLUS loans to approximately one million families last year.¹² That is nearly double the numbers of borrowers and an increase of \$6.3 billion over the past decade alone. Many colleges use these loans when packaging financial aid to fill large gaps in financial aid awards.

Parents can borrow up to the cost of attendance at the schools their children attend, which means families can easily over-borrow, and institutions have an easy source of funds if they wish to raise tuition. Moreover, the federal government does not track or publish the rate at which parents default on PLUS loans at each institution. Lastly, the loans carry a relatively high fixed interest rate of 7.9 percent and origination fee of four percent, which can pose a financial risk to vulnerable families; and the loans are not eligible for repayment options designed to help struggling borrowers, like Income-Based Repayment.

Limit Loans to 150% of Program Length

The package of student aid reforms presented here proposes both annual and aggregate limits for federal student loans and gives colleges the flexibility to adopt lower limits for their students. We also believe that policymakers should add a new program-length limit that would apply in addition to the annual and aggregate limits. The new limit would end loan eligibility once a borrower exceeds 150 percent of the standard time needed to complete the degree or program that he is pursuing. For instance, a student who borrows \$5,000 per year over six years to complete a four-year degree would, under this proposal, exhaust his eligibility for federal student loans, even though he did not exceed the annual or aggregate borrowing limit. This policy is meant to discourage extended and prolonged enrollments beyond 150 percent of the time the student would need to complete his or her program.

The policy would leave in place the annual limit and aggregate limit on borrowing for students who may begin one type of program but switch to another. In other words, the 150 percent

time limit would start over when the student enrolls in a new program, but the overall aggregate and annual limits would still apply. Meanwhile, time spent in remedial education would not count toward the 150 percent program-length limit. The proposal would also prorate annual loan limits if a student pursues his or her program on a half-time basis.

History of Federal Student Loan Interest Rates

Why the Federal Student Loan Interest Rate Is 6.8 Percent

Since the 1960s, the federal government has supported a loan program that helps students pay for the cost of higher education at institutions across the country. While the program has undergone many changes and evolved to provide loans to students from all income backgrounds, its original purpose remains. The program ensures that students can borrow at favorable terms without regard to their credit histories, incomes, assets, or fields of study.¹³ In 2013, students and parents are expected to borrow \$106 billion in federal loans, and over \$800 billion in federal student loans were outstanding in 2011.¹⁴

From the program's inception until 1992, Congress set the interest rate on student loans at fixed rates ranging from 6.0 percent for loans issued in the 1960s to 10.0 percent for loans issued between 1988 and 1992.¹⁵ Congress enacted variable rates in 1992, seeking to better align them with the interest rate the government paid private lenders holding the loans and thereby reduce the government's costs.¹⁶ The new variable rates reset once a year and consist of the interest rate on short-term U.S. Treasury securities plus 3.1 percentage points (a "markup"), capped at 9.0 percent. Congress made minor adjustments to this formula over the subsequent six years, lowering the markup and the cap.

Shortly after the move to variable rates, in 1993 Congress passed the Student Loan Reform Act to establish the Direct Loan program.¹⁷ Congress intended this program, under which the U.S. Department of Education makes loans directly to students, to gradually replace the existing program that subsidized private lenders to make loans (i.e., the bank-based program). At the time, policymakers also sought to more closely link the interest rates borrowers were charged to the rates the government paid to borrow since there would be no further need to link them to subsidies for private lenders.¹⁸ In response, the 1993 law pegged borrower rates to longer-term U.S. Treasury securities that were similar in duration to the student loans, plus a smaller markup of 1.0 percentage point would be calculated for loans issued after July 1, 1998.¹⁹ This formula would also be used to set the interest rate guaranteed to lenders for any loans still made in the bank-based program in 1998 and later.

By the mid-1990s, the Direct Loan program phase-in had not gone as Congress had originally planned; as 1998 approached, the bank-based program still accounted for the majority of newly issued federal loans. However, the pending interest rate change for both borrowers and lenders enacted in 1993 was still set to occur in 1998. As a result, lenders in the bank-based program – who Congress assumed in 1993 would not be playing the major role they still were in 1998 – expressed concerns that the interest rate change would increase their costs and reduce returns

to such an extent that they would no longer be willing to make federally backed student loans.²⁰

Fearing that lenders would flee the program and disrupt loan availability, in 1998 Congress postponed the pending rate changes until 2003 (a permanent fix was too costly) and left the then-current interest rate formulas in place with some minor adjustments (it reduced the markup on the borrower's annual interest rate from 3.1 to 2.3 percentage points). Despite this action, lenders participating in the bank-based loan program continued to express worries over the interest rate structure change, now delayed until 2003. They encouraged Congress to address it before mid-2002 to avoid disrupting student loan availability.

As an alternative to the pending rate change, lenders and some lawmakers proposed making permanent the then-current formulas (short-term interest rates plus 2.3 percentage points). But student advocates and some lawmakers opposed this approach because the formula set to take effect in 2003 (variable rates based on longer-term U.S. Treasury rates plus 1.0 percentage point) produced more favorable rates for borrowers.²¹ At the time, short-term and long-term Treasury rates were similar, meaning that the lower markup built into the pending formula produced lower overall rates.

In late 2001, after months of negotiations, lawmakers proposed a bipartisan compromise that would avert the pending rate change and make permanent the then-current interest rate formula for lenders. It also extended through 2006 the existing variable rate formula for borrowers but established fixed interest rates at 6.8 percent for Subsidized and Unsubsidized Stafford loans made after July 1, 2006.²²

Lawmakers, higher education associations, and student advocate organizations championed the bill because the fixed 6.8 percent interest rate that would start in 2006 was lower than estimates of what borrowers would pay if Congress had maintained the variable formula.²³ In selecting a fixed rate, Congress and advocacy groups decided on 6.8 percent because it was approximately the average of the projected interest rates set to take effect in 2003 based on longer-term U.S. Treasury bills.²⁴ Supporters also cited the certainty that fixed rates provided over variable rates as a benefit to borrowers. The Senate passed the bill unanimously in December 2001, the House passed it with overwhelming support in January 2002, and the president signed it into law.

Congress chose to delay the implementation of the fixed rates until 2006 – maintaining the existing variable rate formula in the meantime – to reduce the costs of the policy over a ten-year budget window. The Congressional Budget Office estimated that adopting fixed rates would reduce the rates for borrowers compared to then-current law, increasing costs for the government by \$5.2 billion from 2007-2011.²⁵ It would have cost more if Congress had chosen to implement the change immediately.

Meanwhile, in the latter half of 2001, the U.S. Federal Reserve was in the midst of reducing its short-term benchmark interest rate in response to a mild economic recession and the terrorist

attacks of September 11th. By the time the ink was dry on the 2002 law that established the fixed 6.8 percent interest rate, the Federal Reserve had cut short-term interest rates below 2.0 percent. It had been as high as 6.5 percent in early 2001. Two more Federal Reserve rate cuts in 2002 and 2003 brought the rate to 1.25 percent and 1.0 percent, respectively. Given the low-interest-rate environment that began in 2002, it appeared unlikely that a fixed 6.8 percent rate would lower costs for borrowers as supporters had previously argued.

A 2005 Effort to Block Fixed Rates Sets Stage for Temporary Rate Cut

Despite the low interest rate environment of the mid-2000s, the fixed rates scheduled to take effect in 2006 received little attention until 2005, when Congress considered proposals to reduce annual budget deficits. That year, Republican majorities in the House and Senate began drafting legislation to cut spending and reduce budget deficits. Both chambers made changes to federal student loans a large component of their respective proposals, spurred by reforms outlined in the president's budget request.

The House plan would have canceled the fixed interest rates set to take effect in 2006, maintaining the existing variable rate formula, which that year set rates between 3.4 and 5.3 percent.²⁶ Sponsors of the proposal argued that variable rates would be better for borrowers and taxpayers. The Senate, however, maintained the fixed rates set to take effect in 2006.²⁷

To meet deficit reduction goals, both the House and Senate bills made a change to the interest rate guaranteed to lenders making federally backed student loans. The bills included a provision that required lenders to rebate interest that borrowers paid in excess of the rate at which the government guaranteed lenders.²⁸ The provision cut spending compared to then-current law because it reduced what lenders could earn on the loans. However, the Senate bill had a larger deficit-reducing effect because it left the scheduled fixed rates in place, increasing the size of the lender rebates. The rebate provision produced \$34.4 billion in savings over ten years in the Senate bill compared to \$14.5 billion under the House's variable rate proposal.²⁹

Why Interest Rates on Some Loans May Double This Year

The president signed a final version of the deficit reduction bill into law in January 2006, which included the Senate's proposal to maintain the fixed rate formula and impose a rebate on lenders.³⁰ Even though Congress enacted the fixed rates in 2002, some observers interpreted Congress' decision to maintain the rates as a Republican-led Congress charging higher interest rates on student loans to reduce the deficit.

In their 2006 campaign platform, *A New Direction for America*, House Democrats claimed that "Congressional Republicans... have allowed student loan interest rates to increase, making student loans even harder to repay." The platform document promised to "slash interest rates on college loans in half to 3.4 percent for students and to 4.25 percent for parents," if Democrats were elected that fall.³¹

After Democrats won majority control of both the House and Senate in 2006, the Congressional Budget Office revealed that the proposal was extremely costly, estimating that the rate cut

proposal would cost \$52 billion and \$133 billion over five and ten years, respectively, compared to then-current policy. The rate cut on PLUS loans for graduate students and parents accounted for about two-thirds of the cost.

The high cost of the proposal did not bode well for the Democrats' campaign pledge because the newly elected majority had also pledged to follow Pay-As-You-Go budgeting principles to fully offset new spending with tax increases or other spending cuts. The Pay-As-You-Go principles meant that lawmakers would have to enact \$132 billion in spending cuts over ten years (a substantial sum) within education or other programs, or raise taxes to offset the new spending in the rate cut proposal. In the end, lawmakers opted to scale back their original proposal to reduce the cost.

Just weeks into the new session of Congress in January 2007, the new House Democratic majority passed a bill to cut interest rates in half, but with significant caveats.³² The bill cut rates in half only for a subset of loans – Subsidized Stafford loans – which are available only to borrowers from families with middle and lower incomes. While both graduate and undergraduate students had been eligible for Subsidized Stafford loans, only undergraduate students were eligible for the rate cut. The bill left rates unchanged for the largest loan category – Unsubsidized Stafford loans – as well as for PLUS loans for parents and graduate students, despite their inclusion in the campaign pledge. All new costs in the bill were offset with spending reductions on subsidies for lenders making federally-backed student loans, ensuring that the bill complied with Pay-As-You-Go principles.

To further reduce the cost of the proposal, the bill phased in incremental rate cuts starting in the 2008-09 school year such that only loans issued for the 2011-12 school year would carry rates of 3.4 percent (half of 6.8 percent). Subsidized Stafford loans issued after that year would again carry a fixed rate of 6.8 percent. In short, the proposed legislation “cut interest rates in half” for loans issued only in one year.

The changes to the original proposal – limiting the cut to Subsidized Stafford loans for undergraduates, phasing it in, and ending it in 2012 – reduced the cost to \$7.1 billion in the ten-year budget window, much less than the earlier estimate for the permanent cut for all loan categories. Making the rate cut permanent for Subsidized Stafford loans for undergraduates after 2012 would have cost an additional \$12.8 billion over ten years.³³

In September of 2007, both the House and Senate passed a budget bill that included the rate cut provision, and the president signed it into law.³⁴ The first rate cut went into effect for Subsidized Stafford loans issued in the 2008-09 school year.

Loans issued for the 2012-13 school year were originally set to carry a 6.8 percent interest rate, because the 2007 rate cuts would have expired. However, in 2012, President Obama included in his fiscal year 2013 budget request to Congress a proposal to extend the rate cut under the 2007 law for one additional year.³⁵ Later that year, Congress passed and the president signed into law a one-year extension of the 3.4 percent interest for Subsidized Stafford loans issued to

undergraduates during the 2012-13 school year.³⁶ The extension was included on a broader piece of legislation that included provisions that the Congressional Budget Office estimated would offset the \$6 billion cost of the extension.³⁷ One of those provisions was a limitation on a separate interest rate benefit available on Subsidized Stafford loans that the president had also included in his fiscal year 2013 budget request.

As it stands today under current law, all-newly issued Subsidized Stafford loans will be issued with a fixed interest rate of 6.8 percent on July 1st, 2013 and thereafter.

Respectfully Submitted,

Jason Delisle
Director, Federal Education Budget Project
New America Foundation

¹ PAYE: 77 Fed Reg. 66087, (November 1, 2012): <http://www.gpo.gov/fdsys/pkg/FR-2012-11-01/pdf/2012-26348.pdf>. 2014 law: P.L. 111-152 §2213. 2007 Law: College Cost Reduction and Access Act, Public Law 110-84 §203(c)(1), 110th Congress (September 27, 2007), Available: U.S. Government Printing Office, <http://www.gpo.gov/fdsys/pkg/PLAW-110publ84/pdf/PLAW-110publ84.pdf>. The 2007 law set the effective date on and after which borrowers could enroll at July 1, 2009.

² The recommended IBR would capitalize a borrower's accrued unpaid interest once his payments under IBR exceed what he would be required to pay under the standard 10-year repayment plan based on his original loan balance. This is consistent with the practice currently under both Old and New IBR.

³ Jason Delisle and Alex Holt, "Safety Net or Windfall? Examining Changes to Income-Based Repayment for Federal Student Loans," New America Foundation (October 2012) http://newamerica.net/publications/policy/safety_net_or_windfall

⁴ P.L. 102-325.

⁵ Cervantes, Angelica, Marlena Creusere, Robin McMillion, Carla McQueen, Matt Short, Matt Steiner, Jeff Webster, "Opening the Doors to Higher Education: Perspectives on the Higher Education Act 40 Years Later," TG Research and Analytical Services (November 2005): http://www.tgslc.org/pdf/hea_history.pdf.

⁶ Delisle, Jason and Alex Holt, "Subsidized Stafford Loans Obsolete and Regressive Due to New Income Based Repayment," Ed Money Watch (November 15, 2012): http://edmoney.newamerica.net/blogposts/2012/subsidized_stafford_loans_obsolete_and_regressive_due_to_new_income_based_repayment-7.

⁷ "FY 2012 Justifications of Appropriations Estimates to Congress: Student Loans Overview," U.S. Department of Education," (March 31, 2011): <http://www2.ed.gov/about/overview/budget/budget12/justifications/s-loansoverview.pdf>, S-15.

⁸ Ibid.

⁹ Delisle, Jason, "Federal Student Loan Interest Rates: History, Subsidies, and Cost," Federal Education Budget

Project (February 2012):

http://edmoney.newamerica.net/sites/newamerica.net/files/policydocs/Interest%20Rates%20Issue%20Brief%20Final_0.pdf.

¹⁰ “Fair-Value Estimates of the Cost of Federal Credit Programs in 2013,” Congressional Budget Office (June 2012): <http://www.cbo.gov/sites/default/files/cbofiles/attachments/06-28-FairValue.pdf>.

¹¹ Delisle, Jason and Alex Holt, “New America Releases Income-Based Repayment Calculator for Forthcoming Report,” Ed Money Watch (October 10, 2012): http://edmoney.newamerica.net/blogposts/2012/new_america_releases_income_based_repayment_calculator_for_forthcoming_report-72603.

¹² Wang, Marian, Beckie Supiano, and Andrea Fuller, “The Parent Loan Trap,” The Chronicle of Higher Education (October 4, 2012): <http://chronicle.com/article/The-Parent-Plus-Trap/134844>.

¹³ White House Office of Management and Budget. Analytical Perspectives: FY2012 Budget, Page 369. <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/topics.pdf>.

¹⁴ White House Office of Management and Budget. Analytical Perspectives: FY2013 Budget. <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/topics.pdf>; Congressional Budget Office. CBO February 2013 Baseline Projections for the Student Loan Program. http://www.cbo.gov/sites/default/files/cbofiles/attachments/43913_StudentLoans.pdf.

¹⁵ Senate Budget Committee. “2002 Student Loan Law Takes Effect, Lowers Interest Rates.” *Budget Bulletin*, August 4, 2006.

¹⁶ Until the early 1990s when Congress created the Direct Loan program, private lenders made and held all federal student loans. The government guaranteed the loans against default losses and guaranteed lenders a minimum interest rate each financial quarter that was based on short-term U.S. Treasury securities (plus a markup) if the rate the borrower paid fell below this formula in any given financial quarter. Congress terminated the guaranteed loan program in 2010 and no new loans have been through the program since July of that year.

¹⁷ *Omnibus Budget Reconciliation Act of 1993*, P.L. 103-66, Title IV.

¹⁸ U.S. Department of Education. “The Financial Viability of the Government-Guaranteed Student Loan Program,” Page 2, February 1998. <http://www2.ed.gov/PDFDocs/stuloan9.pdf>.

¹⁹ Policymakers may also have chosen the new formula because longer-term interest rates are less volatile than the short-term rates used to set student loan rates at the time.

²⁰ U.S. Department of Education. “The Financial Viability of the Government-Guaranteed Student Loan Program,” Page 2, February 1998. <http://www2.ed.gov/PDFDocs/stuloan9.pdf>; Burd, Stephen. “Bill Provides Fix for Dispute Over Interest Rates on Student Loans,” *Chronicle of Higher Education*, June 5, 1998.

²¹ Stoll, Adam. “Memorandum: Student Loans: Replacing the Interest Rate Structure Scheduled to Take Effect in 2003,” Congressional Research Service, June 14, 2001.

²² The law also set a fixed rate of 7.9 percent for PLUS loans made to parents of undergraduates. P.L. 107-139. <http://www.gpo.gov/fdsys/pkg/PLAW-107publ139/pdf/PLAW-107publ139.pdf>.

²³ Bannon, Ellynn. “Student Loan Interest Rate Legislation (S. 1762) Will Make College More Affordable for Millions.” The State PIRGs’ Higher Education Project, January 24, 2002. http://www.pirg.org/highered/media/1_24_02.html.

²⁴ Burd, Stephen. “Lenders and Student Advocates Seek a Deal on Interest Rates.” *Chronicle of Higher Education*, October 12, 2001.

²⁵ Congressional Budget Office. “Pay-As-You-Go Estimate: S. 1762,” January 30, 2002. <http://www.cbo.gov/ftpdocs/32xx/doc3282/s1762.pdf>.

²⁶ U.S. Congress. House. College Access and Opportunity Act of 2006, H.R. 609. February 8, 2005. <http://www.gpo.gov/fdsys/pkg/BILLS-109hr609eh/pdf/BILLS-109hr609eh.pdf>.

²⁷ The law also increased the interest rate charged on Parent PLUS loans made under the bank-based program and created a new category of loans that allowed graduate students to borrow Parent PLUS loans for themselves up to the full cost of attendance.

²⁸ This would have ended an existing policy that allowed lenders to keep the excess interest – sometimes called “floor income” or “windfall profits.”

²⁹ Congressional Budget Office. “Cost Estimate: S. 1932,” January 27, 2006. <http://www.cbo.gov/ftpdocs/70xx/doc7028/s1932conf.pdf>; Congressional Budget Office. “Cost Estimate: H.R. 609,” September 16, 2005. <http://www.cbo.gov/ftpdocs/66xx/doc6648/hr609.pdf>. The Senate proposal also increased the fixed rates on PLUS loans for parents and graduates students to 8.5 percent from 7.9 percent for loans issued under the bank-based loan program and was included in the final law. This change also increased the deficit reduction compared to the House proposal.

³⁰ *Deficit Reduction Act of 2005*. P.L. 109-171. <http://www.gpo.gov/fdsys/pkg/PLAW-109publ171/pdf/PLAW-109publ171.pdf>.

³¹ “A New Direction for America,” Office of House Democratic Leader Nancy Pelosi. <http://www.democraticleader.gov/pdf/thebook.pdf>.

³² “Estimated Impact on Direct Spending of H.R. 2669 with Possible Extensions.” Congressional Budget Office, July 10, 2007. <http://www.cbo.gov/ftpdocs/83xx/doc8303/hr2669Ryanltr.pdf>.

³³ While lawmakers needed to offset all the new spending provisions in the bill with spending reductions to comply with Pay-As-You-Go principles, they also needed to meet a similar requirement to pass the bill under budget reconciliation procedures which require that new spending in a bill be budget-neutral in the latter-years of a budget window. Legislation passed using budget reconciliation procedures cannot be filibustered in the Senate and therefore needs only a simple majority to pass.

³⁴ *College Cost Reduction and Access Act*. P.L. 110-84. <http://www.gpo.gov/fdsys/pkg/PLAW-110publ84/pdf/PLAW-110publ84.pdf>.

³⁵ White House Office of Management and Budget. FY2013 Budget, Page 97. <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf>.

³⁶ *Moving Ahead for Progress in the 21st Century Act*. P.L. 112-557. <http://www.gpo.gov/fdsys/pkg/PLAW-112publ141/pdf/PLAW-112publ141.pdf>.

³⁷ Congressional Budget Office. “Cost Estimate: H.R. 4348, MAP-21,” June 29, 2012. <http://www.cbo.gov/publication/43368>.