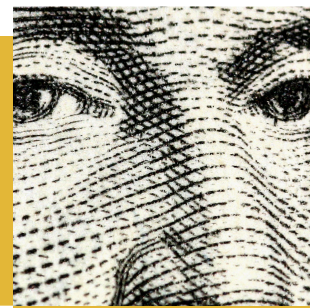
issue briefs

Family Financial Education



2014-11

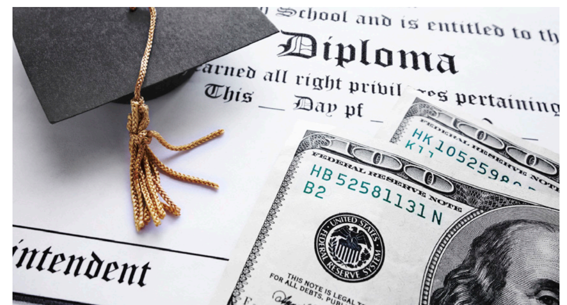
MAINTAINING FAMILY FINANCIAL CREDIT WORTHINESS: MANAGING STUDENT LOANS

This brief summarizes options for managing student loans,[1] focusing on alternatives for borrowers of federal student loans. There are a variety of types of federal loans, each with slightly different features. The most typical examples of federal loans are the Direct Subsidized Loan, Direct Unsubsidized Loan, Subsidized Stafford Loan and Unsubsidized Stafford Loan. The programs described here generally apply to these loans. Ultimately borrowers will have to understand what loans they have, but the topics covered in this brief can help to illustrate potential strategies.

Student loan debt is growing relative to incomes and other forms of debt. For most borrowers, student loans are manageable and a good tool to enable access to higher education—and the greater income potential that education can provide. The challenge comes when a borrower experiences a drop in income or a change in family structure and cannot keep up with payments. It is important to note that managing student loans is not just a financial education issue for younger people; loans may also be incurred by older learners returning to school or job training.

Most student loans are based on a 10 year repayment plan. Ideally most student loans can be paid off in 10 years. Stretching out loans to 20 or 30 years will lower monthly payments, but result in more interest cost. This cost can be significant: on a $24,000 loan a borrower will pay about $9,000 in interest over 10 years, but nearly $20,000 in interest over 20 years and $32,000 in interest over 30 years. But in some cases the 10 year repayment term is simply unaffordable so other options have to be explored. This brief provides an overview of the options troubled borrowers have for repaying federal student loans under the standard payment schedule.

1 Note: see Lunchtime Learning Brief 2012-11. Financing Higher Education for more background on education loan types and options.



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Repayment Options

Like mortgages or credit cards, borrowers have the option to seek ways to work out problems when they have trouble making payments. Unlike other forms of debt, however, student loan borrowers are not likely to escape student loan debt through bankruptcy. Other than special cases of severe disability, death, or certain forgiveness programs, student loans are unlikely to "go away".[2] Federal student loans do have a number of repayment options, including forbearance, extended payment plans, and deferment, some of which can significantly lower monthly payments relative to income.

Negotiated Payments

Any borrower can contact his or her student loan servicer (the loan "servicer" is the company that collects payments and deals with the borrower—it may or may not be the original lender of the loan), or servicers if the student has multiple loans, and discuss alternative repayment options. These range from short-term plans to lower payments to alternative payment schedules.

A common type of repayment option is forbearance. Borrowers can request forbearance from their loan servicer, and the servicer will usually ask the borrower to show there is some special circumstance that makes maintaining payments difficult. Forbearance simply suspends payments, but the loan will still accrue interest. The unpaid interest costs are then capitalized into the loan balance due, increasing the total amount to be repaid and increasing interest costs overall. This is generally a temporary measure and not a long term solution.

Borrowers, especially in the early years of their loan, might request other options to change the payment schedule over time. Some loan servicers will offer an income-sensitive repayment plan, which is based on annual income. Each year a borrower in an income sensitive plan will be asked submit income information and the loan servicer then calculates a payment that is up to 15 percent of income. Monthly payments can change as the borrower's income changes, both up and down. Because these are private loan modifications, not plans offered through the US Department of Education, each servicer's formula for determining monthly payments can vary. A related option is a graduated repayment plan, where payments are low in the early years and then higher in later years. This strategy is based on the idea that a younger student will have lower income when first leaving school, and increased income with more work experience. However, interest costs tend to be higher relative to a standard 10 year repayment plan.

Repayment Plan	Monthly Payment	Qualifications
Standard Repayment Plan	Fixed monthly amount ($50 Minimum) for up to 10 years	Standard terms.
Graduated Repayment Plan	Payments increase every 2 years. Up to 10 years depending on loan amount. Fixed rates.	Only for consolidated loans.
Income-Based Repayment Plan (IBR)	• 15 percent of discretionary income for up to 25 years	Borrow must have a partial financial hardship. After 25 years of payments, the outstanding balance is canceled (which may trigger income tax)
Pay As You Earn Repayment Plan (PAYE)	• 10 percent of discretionary income, for up to 20 years	Loan made between October 1, 2007 and October 1, 2011 and show partial financial hardship. After 20 years of payments, the outstanding balance is canceled (may be taxable)

See the online Repayment Estimator for estimates of monthly payments under these options for federal student loans.

2 See https://studentaid.ed.gov/repay-loans/forgiveness-cancellation for current discharge conditions

Loan Deferments or Cancellations

A deferment of student loan payments means having a temporary time when no payments are due. Borrowers have to show an economic hardship, such as being unemployed, or out of the workforce to return to school full-time. Depending on the loan, deferment will either stop principal and interest from accruing on the unpaid balance, or only defer the principal of the loan. In the latter case, interest will continue accrue. Usually you have to be in good standing--not in default--although a retroactive deferment is possible in the case of a major life event (e.g. health emergency). Loan servicers will ask for paperwork to prove the hardship qualifies for a deferment. Cancellations are more rare and only provided under certain circumstances. Conditions for deferments or cancellations could include:

- Death: The executor can cancel any loans outstanding.
- Permanent total disability: Any condition which prevents work indefinitely. A letter from a doctor or SSDI or DI record is needed.
- Temporary total disability: A three year deferment of borrower of his/her spouse or a dependent has a disability.
- Unemployed: If currently unemployed, but still looking for work. Proof of unemployment benefits and being actively in a search for a job is required
- Economic hardship: Receiving public assistance.
- Currently enrolled in school: On at least a half-time basis.
- Uniformed service: U.S Military or the Public Health Service.

Federal Repayment Options

There are a number of options more formally determined by the Department of Education, including several versions of income sensitive repayment plans. These options generally also include more oversight and a form of subsidy from the federal government.

Income-Based Repayment (IBR) was the first of the new options offered on federal loans, starting in 2007. When a borrower enrolls in IBR, his or her monthly loan payments are calculated based on 15% of discretionary income (not gross income or adjusted gross income—AGI—as reported for tax filing). Discretionary income is defined as the difference between 150 percent of the statewide poverty guideline by family size and state of residence (regardless of what state in which the student attended school). Importantly, these loans include a form of subsidy from the federal government, so the loans will not negatively amortize—that is end up accruing interest on interest in the loan balance. For up to three years after repayment begins, the government will pay portions of the interest accruing due to the lower payments. Additionally, after 25 years of qualifying payments, any outstanding balance is forgiven. Borrowers have to show a hardship to qualify, and not every borrower who requests IBR will be approved. (The concern is that there are perverse incentives for borrowers to both borrow more and then earn less).

For a borrower with a long term hardship and a low chance of ever having a higher income, these plans can be advantageous. But the interest costs are higher and there is the possibility that these loans can accumulate interest and actually increase the loan balance (negative amortization). Furthermore, any loan amount forgiven is a taxable event, and the IRS may end up assessing federal income tax on that amount, in addition to state taxes. This might be a significant financial obligation that could present a difficulty in the (albeit distant) future. Borrowers can estimate their monthly payments online.

A related federal loan option is Pay As You Earn (PAYE). Like IBR, this program bases monthly payments based on the borrower's discretionary income, but uses a more generous 10% formula. With PAYE loan forgiveness can occur sooner—after 20 years of monthly payments. However, PAYE is only an option for loans a borrower took on after October 1, 2011. A related approach is the Income-Contingent Repayment Plan which applies only to consolidated loans. In all cases borrowers have to show a partial hardship—which is when the 10-year standard monthly payment (when the borrower first started the loan) is more than 15% of discretionary income.

Another option is not a change in payments, but offers a route to tax-free loan forgiveness for qualified borrowers. The Public Service Loan Forgiveness program is a targeted program for students who work in public service. The program provides tax-free loan forgiveness to federal loan borrowers after 120 monthly loan payments. The borrower

must make 120 on-time, full monthly payments, and only payments made after October 1, 2007 qualify. Qualifying employment includes a job in federal, state, or local government, military, or a not-for-profit organization (501(c)(3)). Certain emergency management, public safety/law enforcement, public health, public education, early childhood education or public interest law may qualify also.

Avoiding Problems

Many borrowers set up a standard payment plan and use automatic debit. This might include paying extra each month and paying off debt faster than planned, which lowers interest costs overall. Because some plans required on-time payments, late payments not only harm credit history but limit future repayment options. A common problem is that student loan borrowers miss their first loan payment—so this is an important issue for even very new borrowers to address. Setting up payments automatically from a bank account reduces the chances of late payments, but the borrower has to maintain a sufficient balance each month to cover the payment.

Most borrowers have multiple loans (perhaps 1-2 per semester accumulated over 4-6 years, so 15 or more loans are possible). Tracking this many loans can be difficult. Each will have different interest rates, end dates and month payments. The online National Student Loan Data System tracks all federal student loans. Once registered on the website, a borrower can see the balance, interest rates and loan terms on each loan. It is important to remember that a single payment will be allocated to each loan. Borrowers might, for example, want to pay off the highest rate loans first. However, any additional contributions to pay off loan balances are allocated across all loans equally, regardless of interest rate, unless the borrower specifically requests otherwise.

It is critical that borrowers maintain good records and keep important documents organized, including:

- Loan documents (or promissory note)
- Account numbers for each loan
- Loan servicer(s) contact information
- Payment schedules
- Records of monthly payments
- Dates of any contact with servicers (on the phone and online)
- Documentation letters for any loans paid off

Consolidation: Dealing with Multiple Loans

Loan consolidation can combine all student loans into one loan with one payment. At the same time, loans are often put into one payment schedule with one term. The term can also be extended (up to 30 years). Consolidated federal loans can also include a fixed interest rate, rather than the adjustable rate used for many loans. The fixed interest rate is based on the weighted average of the interest rates on the loans being consolidated, rounded up to the nearest one-eighth of 1%. However, unlike the original federal loan, any interest rate discounts and some deferment options might not be possible. Consolidated loans cannot be removed—in practice the loans that were consolidated were paid off and a new loan has taken the place of the smaller loans. The online Repayment Estimator offers estimates of monthly payments under consolidation. Generally, consolidation is only available after leaving school, and no more new loans are being borrowed.

Learning More

Lenders may not inform borrowers about every option. Borrowers have to do some research or to seek advice from trusted counselors. The online Financial Awareness Counseling provides tools and information to help borrowers understand student loan options and manage personal finances overall. There are professional counselors who claim expertise on student loans, but the quality and reliability of these providers may vary.

Note that students who took out private loans or parents who took out loans behalf of their children are not necessarily covered by all of these alternatives, although many of the concepts are similar (and most borrowers of private loans also have federal loans).

In general, a key concept for community-based educators is to encourage borrowers to pay attention to loan terms, keep organized about payments, and informed about options if paying loans becomes a problem. Most borrowers will be able to manage their loans well in time, but often need help getting started.

More Resources:

Project on Student Debt

National Consumer Law Center's Student Loan Borrower Assistance Project.

Federal Student Aid Ombudsman

https://studentloans.gov/myDirectLoan/counselingInstructions.action

https://studentaid.ed.gov/repay-loans/disputes/prepare/contact-ombudsman

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