THIRD WAY

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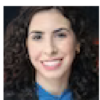
How Student Loan Balances Can Grow Over Time



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When you take out a loan, the goal is clear: to pay it back quickly, and not pay a dollar more than you have to in interest. And when you make payments and see the balance go down, it's gratifying to see progress toward that goal. But sometimes, low-income student loan borrowers enrolled in income-driven repayment (IDR) plans experience the *opposite*—their balance is going up and their monthly payments aren't making a dent in their principal.

The Department of Education (Department) has put forth some bold fixes to prevent this damaging cycle—called negative amortization—in its new IDR proposal. [1] But why does this balance growth happen in the first place, and how is it impacting student loan borrowers?

Lower Payments, Bigger Balances?

Student loans are repaid in monthly installments, with the payment amount going first toward the interest that has accrued and then toward the principal balance. This works out very neatly for borrowers on the standard 10-year repayment plan who make regular payments—their 120

installments cover a little less interest and a little more principal each month, until both categories are zeroed out at the end of the repayment window.

But nearly half of borrowers—47%—are enrolled in an income-driven repayment plan, which ties their monthly payment amount to their income and spreads payments out over a longer time horizon of 20 to 25 years. [2] IDR offers several benefits to borrowers, especially smaller student loan bills for lower-income borrowers whose monthly payments on the standard plan would be unaffordable. In IDR, payments can be as low as $0 for those with incomes near the poverty line. But when these smaller payments don't cover the interest that accrues on the loan each month, IDR plans can also lead to balance *growth* even when borrowers are making regular payments.

Take the case of a hypothetical borrower named Alex. Alex took out $30,000 in federal student loans (the average amount for undergraduate borrowers) for their bachelor's degree at an interest rate of 4.5%. The $310.92 monthly payment on the standard 10-year plan would be unmanageable for Alex's income, so they enroll in an IDR plan through which they are required to make monthly payments of $100 in their first year of repayment. But the interest charge alone for the first month comes to $112.50—more than the required payment itself, without even touching the principal. Some IDR plans would subsidize portions of that unpaid interest. Alex's plan does not, so their balance grows by $12.50 each month. After a full year of payments, their balance will be $150 more than what they borrowed, and they will have paid $1,200 toward accrued interest but $0 toward their principal.

Bigger Balances, Higher Barriers to Repayment

Borrowers with high debt relative to their incomes are most severely impacted by balance growth. That means borrowers who are already struggling can face higher barriers to repayment even when, like Alex, they have done everything "right" by opting into an IDR plan to make their payments more manageable and paying on time each month. Black borrowers, who borrow larger sums and experience greater repayment challenges due to labor market discrimination, disproportionately experience the barrier posed by negative amortization. [3] Within 12 years of entering college, 52% of Black borrowers who did not consolidate their student loans owed more than the amount they originally borrowed to attend—more than double the share of white borrowers who experienced balance growth (22%). [4]

Low-income borrowers and non-completers are also more likely to face higher principal balances over time. Among borrowers whose family income was at or below the federal poverty line when they entered college, 34% saw their principal balance exceed the amount they originally borrowed within 12 years compared to 22% of those from families with incomes surpassing 250% of the poverty line. Just under a third (32%) of borrowers who had not earned a degree or credential within six years of entering college had a higher principal within 12 years—making them 60% more likely than bachelor's degree recipients to face balance growth. [5]

Ballooning balances create not only a financial burden, but also a demoralizing psychological barrier to repayment. Seeing their debt grow over time leaves borrowers feeling overwhelmed, frustrated, and stressed out. Borrowers who participated in focus groups conducted by The Pew Charitable Trusts reported harboring "resentment" toward growing debt that felt "insurmountable" and expressed that having a larger balance demotivated them from continuing to repay. [6] Black IDR borrowers surveyed by The Education Trust used words like "trap" and "scam" to describe their student loans, and 71% said their loans negatively impacted their quality of life. [7]

It's true that for many IDR borrowers, their remaining higher balances would be eligible for forgiveness at the end of their plan's 20- or 25-year repayment period. But that forgiveness is often treated as taxable income, adding to the total cost to the borrower even as they attempt to access the long-awaited benefit of IDR. The light of forgiveness at the end of a two-decade tunnel does little to improve borrowers' experiences month in and month out as they watch their balances go up regardless of whether they make payments.

Adding insult to injury, a combination of administrative complexity and mismanagement by the Department and student loan servicers has resulted in a rocky, unreliable pathway to forgiveness for IDR borrowers. Thousands of loans potentially eligible for forgiveness are in a state of limbo, with glaring gaps in the Department's data leaving officials unable to conclusively determine whether those borrowers have made enough qualifying payments to have their accounts zeroed out. [8] These uncertainties contribute to a vicious feedback loop: financial and psychological harm caused by growing debt dampens trust in the repayment system, and when borrowers feel they cannot rely on the information they receive or the promise that their loans will be forgiven down the line, they are at higher risk of losing motivation and falling off track with their payments in the first place. [9]

What the Biden Administration Has Proposed

The Biden Administration has proposed new rules for IDR plans, including substantive reforms to the terms of the Revised Pay As You Earn (REPAYE) plan. [10] Accrued, unpaid interest would be waived for borrowers making payments in this plan under the proposal, meaning that when monthly payments are not sufficient to cover the interest that is due, the federal government will forgive that outstanding interest and prevent balances from increasing. This change will make the REPAYE plan significantly more generous than other IDR plans, in which the government waives none or only a portion of accrued interest not covered by payments. The current REPAYE plan waives 50% of borrowers' unpaid monthly interest, with the rest building up over time.

Conclusion

Income-driven repayment plans offer important benefits and protections—if borrowers can reliably access them. Principal balance growth due to negative amortization increases the debt

burden on borrowers who are already struggling to repay their student loans. As IDR enrollment increases, so will the need to ensure that borrowers looking to these plans for greater security are able to see progress toward their repayment goals.

TOPICS

HIGHER EDUCATION 632

ENDNOTES

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