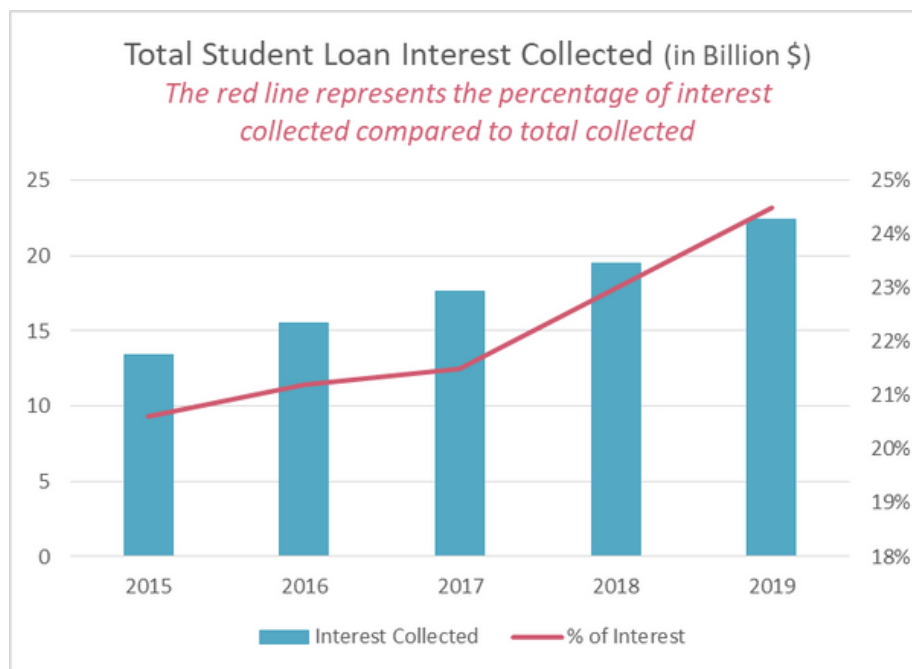


Losing Interest: No Interest Student Loans with a Cost Offset

PROBLEM

An increasingly large share of student borrowers today are unable to pay down their loan principal. Their balances grow primarily because interest is accumulating faster than the payments they are making. Known as negative amortization, the accumulated interest is added onto the original loan principal, compounding interest and increasing future repayment obligations.

Nearly one-quarter of all payments made by student loan borrowers in 2019, were interest payments. Interest payments alone reached \$22.4 billion, up from \$13.1 billion in 2015.



Source: <https://www2.ed.gov/about/reports/annual/2019report/agency-financial-report.pdf>

Many borrowers who face difficulties repaying their loans opt into income-driven repayment (IBR) plans that allow them to make lower monthly payments. However, when those lower payments do not cover the interest on the loan, interest accrues each month resulting in negative amortization, and the balance grows over time.

Borrowers are drawn to these plans because after 20 or 25 years of repayments, the government forgives the unpaid loan balances. However, since the amount to be forgiven often balloons to astronomical amounts, borrowers are stuck with enormous tax costs on their forgiven debt. Thus, an unintended result of our current system means that borrowers in financial hardship end up paying more over the lifetime of their loans than wealthier borrowers.

Rising loan balances, even while borrowers are in repayment, is a growing problem that disproportionately affects low-income borrowers and students of color. Black graduates who currently experience labor market discrimination and occupational segregation are also much more likely to experience negative amortization.

Nearly half (48 percent) of black graduates see their undergraduate loan balances grow after graduation, compared to just 17 percent of white graduates, according to a 2016 [study](#) from the Brookings Institute. A 2019 Brandeis University [study](#) laid bare the stark consequences of growing loan balances on students of color: twenty years into repayment, the median Black borrower still owed 95 percent of the original amount they'd borrowed, while the median white borrower had almost fully repaid their loan.

While IBR plans can prevent borrowers from falling into default, many borrowers report that they also negatively impact their mental health. In 2021, the Education Trust published a [survey](#) of Black student loan borrowers: 78 percent of borrowers enrolled in IBR plans reported that loans were their primary source of financial stress and 67 percent of borrowers enrolled in an IBR plans reported that loans had a negative impact on their mental health.

An anticipated interest rate increase by the Federal Reserve will only add to the burden of new borrowers. The Congressional Budget Office (CBO) projects that interest rates for new undergraduate student loans are expected to rise from 4.99% to 5.85% over the next ten years (see table below), adding thousands of dollars in additional interest payments to the typical student's costs.

Even for a borrower on a standard 10-year repayment plan, this higher interest rate will cost \$2,000 in additional interest payments for these future borrowers. For borrowers experiencing negative amortization, the cost will be significantly higher.



Table 6.
Federal Student Loan Programs: Projected Interest Rates

	By Award Year, Percent										
	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29	2029-30	2030-31	2031-32	2032-33
Subsidized and Unsubsidized Loans to Undergraduate Students 10-year Treasury + 2.05% Capped 8.25%	4.99	4.89	5.08	5.21	5.47	5.76	5.85	5.85	5.85	5.85	5.85
Unsubsidized Loans to Graduate Students 10-year Treasury + 3.60% Capped 9.50%	6.54	6.44	6.63	6.76	7.02	7.31	7.40	7.40	7.40	7.40	7.40
PLUS Loans to Graduate Students and Parents 10-year Treasury + 4.60% Capped 10.50%	7.54	7.44	7.63	7.76	8.02	8.31	8.40	8.40	8.40	8.40	8.40

Borrower interest rates are fixed for the life of the loan and adjusted based on the final auction in May for 10-year Treasury notes. That rate is in effect for all newly issued loans from July 1 through the following June 30.

The borrower interest rates used for estimating the cost of the student loan program are different from the rates shown above. The rates used for cost estimating are projected using a Monte Carlo method to capture the effect of a cap on interest rates under current law.

Source: <https://www.cbo.gov/system/files/2022-05/51310-2022-05-studentloan.pdf>

SOLUTION

While addressing the burden of student debt must take a multi-faceted approach, one important step policymakers should take is to remove the interest obligation on students. The government can offset the cost of waiving interest payments by investing the principal payments to generate revenue.

Here's how this new system would work:



The federal government lends no interest loans to students



Borrowers repay principal only over a set period of years



The principal repayments are invested in risk-free assets to generate a return over time



Once matured, the funds are used to cover administrative costs and issue new student loans

First, the federal government would provide no interest loans to student borrowers. Over a set period of years, borrowers would repay the principal of the loan.

As principal repayments are received by the federal government, they would be invested in a risk-free asset (such as a bond issued by the Federal Reserve) to generate a return over time. When the bond comes due, the Federal Reserve would return the principle - plus interest - to the federal government, where the funds would be used to cover the administrative costs of the program and to issue new no interest student loans. Depending on how the investment is structured, the government can potentially generate not only a cost offset, but a profit as well, which could be directed to providing more need-based grant aid.

The table on the next page summarizes the savings borrowers receive with no interest loans compared to the existing standard repayment plan and an income-based repayment (IBR) plan. The average debt load for borrowers is \$35,000 and a 20-year repayment plan for a no interest loan would reduce monthly payments from \$383 to \$145. Community college students, who typically borrow much less, would have even smaller payments. Removing interest payments would also save the average student borrower at least \$10,000 over the lifetime of their loan.

Compared to an IBR plan, a no interest repayment plan is simple. Not only is the monthly repayment amount lower, it also stays the same over the lifetime of the loan instead of fluctuating or increasing over time (which an IBR does since it's based on income).

Moreover, borrowers in IBR end up paying more over time (in this case \$18,500 more) and they're expected to pay income tax on the amount that's eventually forgiven (\$16,620 in this case).

Comparing Repayment Terms (for a borrower with \$35,000 in undergraduate loans)

	Standard Repayment	Income-Based Repayment	No Interest Repayment
First Payment	\$383	\$141	\$145
Last Payment	\$383	\$327	\$145
Total Balance Paid	\$45,960	\$53,506	\$35,000
Total Forgiven	\$0	\$16,620	N/A
Repayment Term	~10 years	~20 years	~20 years

Calculations are based on a single borrowers who has \$35,000 undergraduate student loans enrolled in a Revised Pay As You Earn plan with an adjusted gross income of \$35,000 and a 3.5% annual income growth
 Source: <https://studentloanhero.com/calculators/student-loan-revised-pay-as-you-earn-calculator/>

CONCLUSION

Multiple factors need to be considered as policymakers and leaders look to address the burden of student loan debt. It is clear that a one-size-fits-all approach will not address the issue in its entirety. One way to provide substantial relief to current and future borrowers is to provide no interest student loans with a cost offset.

- Reduce monthly payments for student loan borrowers to a sustainable and fixed level, allowing them to save for a home, start a business, purchase a vehicle, or start a family.
- Avoid the continued need for periodic loan forgiveness plans by eliminating skyrocketing loan balances driven by interest.
- Provide predictability and stability to the college financing system, relieving stress and uncertainty for student loan borrowers.
- Provide universities with a secure source of financing at a time when demographic shifts are already creating financial challenges.
- Allow the federal government to take steps to truly help student borrowers without incurring loses - in fact, depending on how it's structured, investment of principal payments could generate more revenue, which could be used to provide more need-based grants to eligible students.

Eliminating the interest payment burden would bring substantial relief to millions of student loan borrowers and our entire economy. With the cost offsetting mechanism proposed here, we have the opportunity to provide relief and put our student loan system on a sound financial footing.