Policy proposal: Hardship and debt-to-income ratio
Negotiated Rulemaking 2023 - Student Loan Debt Relief
November 14, 2023

Summary

To target excessively burdened borrowers across the economic spectrum, we propose a new hardship program that offers borrowers periodic opportunities to apply for an adjustment to their outstanding balance that reduces their debt-to-income (DTI) ratio to a level that would reduce hardship.

Proposal: Opportunities for period relief adjustments based upon debt-to-income ratio

To target excessively burdened borrowers across the economic spectrum, we propose a new hardship program that offers borrowers periodic opportunities to apply for an adjustment to their outstanding balance that reduces their debt-to-income (DTI) ratio to a level that would reduce their hardship.

We expect borrowers to pay down their balance over the course of their repayment period, and thus, their outstanding balance would decline in relation to their income. One would also expect that most borrowers' incomes would grow over time. When this does not happen then a borrower is in hardship. The graduated levels of DTI suggested below to which a borrower could have their balance re-adjusted reflect estimates of a reasonable loan balance in relation to a borrower's time in repayment.

Under this policy, the account adjustments would periodically cancel a portion of a borrower's outstanding debt to result in the maximum DTI ratios below:
- 4 years: 85-125% of income
- 8 years: 65-100% of income
- 12 years: 45-75% of income
- 16 years: 25-50% of income
- 20 years: Full cancelation, or 25% of income

Or

- 4 years: 20-40% of income
- 6 years: 40-70% of income
- 12 years: Full cancelation

The maximum DTI levels could also be adjusted to a sliding scale, in which higher-income borrowers are expected to manage a higher DTI. This adjustment schedule could also be constructed on a 10 or 12-year timeline.

To account for short-term spikes or drops in annual income, borrowers' eligibility could be evaluated based on an average of the annual income earned in each of the 3 years preceding the application (excluding periods of in-school deferment and medical residency).

Ideally, this program would be automatic based on income data from tax records; when this is not possible, a simple application-based process could be implemented.

Background: Student loan debt and hardship

Student loan debt works as an obstacle to economic mobility and a source of financial difficulty for borrowers across the economic spectrum. Despard et al. highlights some key measures of hardship that emerge from the academic literature on student debt and economic well-being:

- "Households with student debt obligations fare worse on measures of assets and net worth compared to non-indebted counterparts (Elliott & Nam, 2013)."
- "Analyzing data from the Survey of Consumer Finances (SCF), Bricker and Thompson (2016) found that households with student debt were 4 percentage points more likely to be 60 days late on bill payments and 18% more likely to have been denied credit, or feared credit denial, than those without student debt."
- "Student debt is also associated with increased odds of bankruptcy for some borrowers. Using SCF data over a longer time period (1995 to 2010), Gicheva and Thompson (2015) found that as the amount of student debt increases, the likelihood of declaring bankruptcy increases, even after controlling for income, predicted earnings, and other demographic factors. The strength of the relationship between student debt and bankruptcy was greater for households with at least one borrower who did not complete their degree and decreases, but was still statistically significant, when controlling for economic condition in their models (aggregate unemployment and bankruptcy rates). In contrast to other research, student debt amount was unrelated to late bill payments or credit denials (Gicheva & Thompson, 2015)."
- "Despite wage and earnings premiums long associated with earning a college degree (Greenstone & Looney, 2012; Hershbein, Harris, & Kearney, 2014), student debt may constrain graduates' investment choices and inhibit the accumulation of assets (Gicheva & Thompson, 2015). College-educated households without student debt have seven times the net worth of similar households with student debt (Fry, 2014). Retirement savings are 52% higher for non-indebted households than indebted ones (Elliott, Grinstein-Weiss, & Nam, 2013). Because students borrow against future earnings, higher borrowing rates during college reduce the availability of discretionary income to build wealth post-college (Elliott & Lewis, 2015). This may be particularly true for recent, early-career graduates who are repaying debt while earnings are lower (Hershbein et al., 2014)."
- "Conventional life-cycle vehicles through which households accumulate assets may also be affected by student debt. College graduates with large student debt levels had significantly lower odds of purchasing a home than those without outstanding debt (Brown & Caldwell, 2013; Brown et al., 2015; Gicheva & Thompson, 2015; Shand,

2007), which may be due to reluctance to assume more debt (Houle & Berger, 2015). These divergent rates of homeownership amount to vastly different short- and long-term wealth profiles. Compared to homeowners without student debt, indebted homeowners are estimated to have $70,000 less in home equity (Hiltonsmith, 2013)."

- "A small body of evidence has demonstrated that the burden and stress associated with student debt may have adverse mental or physical health impacts... Walsemann, Ailshire, and Gee (2016) found that higher levels of student debt among Black young adults were associated with fewer hours of sleep, though no such relationship was found among White and Latino young adults."
- "Participants with student debt had 51%, 19%, and 27% greater odds of experiencing material hardship (p b 0.001), health care hardship (p b 0.05), and financial difficulty (p b 0.01), respectively, compared to participants with no student debt. Certain demographic variables were also associated with outcomes. An increase in one year in age was associated with greater odds for healthcare hardship (p b 0.01). Women had 59%, 31%, and 31% greater odds than men of experiencing material hardship, health care hardship, and financial difficulty. Participants with dependents had 88% and 67% greater odds of material hardship, and financial difficulty (both p b 0.001), respectively, compared to participants without dependents."
- "Participants with student debt had greater odds of skipping housing payments, bill payments, medical care, dental care, and prescription medications, as well as experiencing food insecurity and overdrawing bank accounts."[1]
- This study found that participants with student debt had
    - 51% greater odds of experiencing material hardship (p < 0.001)
    - 19% greater odds of experiencing health care hardship (p < 0.05), and
    - 27% greater odds of experiencing financial difficulty (p < 0.01)
- respectively, compared to participants with no student debt. (12)

Zhan (2020), similarly, found that "Young adults who had student loan debt were more likely to experience financial hardships. For example, the young adults who had student loan debt were about 0.8 times more likely to have difficulty in paying bills, 1.3 times more likely to have financial difficulty in meeting health care needs, and 2.3 times more likely to be late on mortgage payment."[2]

Frameworks for relief based upon debt-to-income ratio

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[1] Despard, M. R., Perantie, D., Taylor, S., Grinstein-Weiss, M., Friedline, T., & Raghavan, R. (2016). "Student debt and hardship: Evidence from a large sample of low-and moderate-income households." *Children and Youth Services Review*, 70, 8-18, https://www.sciencedirect.com/science/article/abs/pii/S0190740916302705.

[2] Zhan, Min. (2020). "Student Loan Debt and Financial Hardship among Young Adults," *International Consortium for Social Development*, https://scholar.archive.org/work/4d3g72edb5gljmklg5qa7okuei/access/wayback/https://quod.lib.umich.edu/cgi/p/pod/dod-idx/student-loan-debt-and-financial-hardship-among-young-adults.pdf?c=sdi;idno=17872073.0042.203;format=pdf.

Eaton et al. demonstrate that "student debt cancellation—at all proposed levels—is progressive; it would provide more benefits to those with fewer economic resources and could play a critical role in addressing the racial wealth gap and building the Black middle class. The reason for this progressivity is simple: People from wealthy backgrounds (and their parents) rarely use student loans to pay for college."[3]

Understanding the relationship between debt and income is a standard way to assess debt burden. In its 2019 Survey of Consumer Finances analysis, the Federal Reserve uses "three measures of debt burdens: leverage ratios, debt-to-income ratios, and payment-to-income ratios. Leverage ratios compare debts to assets, debt-to-income ratios compare debt to income, and payment-to-income ratios compare payments made on debt relative to income. All three ratios can be constructed either in aggregate or as a median for debtors."[4]

This proposal recommends using debt-to-income ratio as a means of assessing and alleviating student loan debt burden. There is a range of perspectives on what constitutes an "affordable" versus an "excessive" debt, and they are generally offered on either a monthly payment-to-income ratio or a total debt-to-annual income ratio. One can also be derived from the other based on the interest and payment period.

Estimates of an affordable monthly payment-to-income threshold generally range from 5-15%, with 8% as a level that was generally accepted by scholars for a significant period.[5] (The Saving on a Valuable Education, or SAVE, income-driven repayment plan, uses 5% of monthly discretionary income as an affordable level.)

However, most estimates have historically been based upon mortgage lending practices which seek to assess the level at which a borrower is likely to default.[6] The level at which a student loan borrower experiences hardship may differ from the circumstances that lead someone to default on a loan and may correspond to less extreme metrics of financial hardship, such as an inability to save for retirement or emergencies. We encourage the Department to think beyond extreme hardship (as indicated by measures such as default, delinquency, or reliance upon federal benefit) to those that indicate student loans are a financial burden and a barrier to economic well-being.

For example, a recent survey of student loan borrowers found that, across generational divides, student loan borrowers struggled with this basic level of economic well-being. Below are the

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[3] Eaton, C., Goldstein, A., Hamilton, L., & Wherry, F. (2021). "Student Debt Cancellation Is Progressive: Correcting Empirical And Conceptual Errors." Roosevelt Institute, https://rooseveltinstitute.org/publications/student-debt-cancellation-is-progressive/.

[4] Bhutta et al., (2020). "Changes in U.S. Family Finances from 2016 to 2019: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, 106, 24, https://www.federalreserve.gov/publications/files/scf20.pdf.

[5] Baum, S. & Schwartz, S. (2006). "How much Debt is Too Much Debt?" *The College Board*, https://files.eric.ed.gov/fulltext/ED562688.pdf.

[6] Ibid.

proportions of those surveyed who delayed the below "significant financial decisions…
specifically because of the student loan debt for [their own] education."[7]

	Saving for retirement	Saving for emergencies	Paying off other debt
Gen Z	26%	25%	21%
Millennials	28%	31%	25%
Gen X	26%	28%	24%
Baby boomers	22%	23%	24%

Source: Hanneh Bareham, "Survey: Student loans have delayed wealth-building for Gen Z and millennial borrowers," 2022, Bankrate.com, https://www.bankrate.com/loans/student-loans/financial-milestone-survey-2022/.

Kantrowitz, who accepts 10% as the threshold for an "affordable" debt-service-to-income ratio, shows that a 10-15% monthly payment corresponds roughly to the "rule of thumb" that "total student loan debt at graduation should be less than the expected annual starting salary."[8] The Texas Higher Education Coordinating Board, in its strategic state plan for higher education *60x30TX*, calls for all students to graduate with less "debt that amount[s] to less than 60% of first-year wages."[9] These two threshold levels for overall debt-to-income ratio (between 60% and 100% of original principal to first-year salary) upon graduation may be understood as general benchmarks the Department could begin at to assess reasonable levels of debt-to-income ratios that could inform hardship debt relief policies.

Conclusion

Reducing excessively burdened borrowers' DTI ratios will allow them to make progress toward paying off their loans and remove what many borrowers experience as an insurmountable barrier to economic well-being. It will better allow them to pursue opportunities like homeownership, entrepreneurship, and parenthood, while improving their ability to access credit while stimulating the wider economy.

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[7] Hanneh Bareham, "Survey: Student loans have delayed wealth-building for Gen Z and millennial borrowers," 2022, Bankrate.com, https://www.bankrate.com/loans/student-loans/financial-milestone-survey-2022/.

[8] Kantowitz, M. (2015). "Who Graduates with Excessive Loan Debt?" *Student Aid Policy Analysis Papers*, http://www.studentaidpolicy.com/excessive-debt/Excessive-Debt-at-Graduation.pdf.

[9] Texas Higher Education Coordinating Board, "2022–2030 Strategic Plan: Building a Talent Strong Texas," https://reportcenter.highered.texas.gov/agency-publication/miscellaneous/building-talent-strong-texas/.