

## Policy options for the post-18 review: modifying interest rates

### Summary

1. One of the concerns that has been raised about the student finance system is the rate at which interest accrues on loans from the Student Loans Company (SLC). Headline rates above 6% grab the headlines as being unfair when the cost of Government borrowing is a fraction of this.
2. However, the challenge is that charging a real rate of interest actually makes the SLC system more progressive: in other words, it is designed to ensure that medium to high earning graduates ultimately pay more, while lower earning graduates benefit because of the high starting threshold for repayments and the automatic 30-year write off of loans.
3. Lower interest rates would shift more of the cost of higher education onto taxpayers as graduates (and particularly higher earners) pay back less in total. For example, the long-run cost of reducing the current interest rate by 1% would be £824m per cohort<sup>1</sup>. This would increase the total cost of student finance for taxpayers by almost £1,700 for every student. Moving interest rates during study down to Consumer Price Index levels and reducing the long-term interest rate by 1% would cost around £1.04bn per cohort.
4. The complexities of Government accounting rules also mean changes to the interest rate have an impact on the Government's deficit figure. In a scenario where no interest is charged during study and the headline rate afterwards is cut by 1% we estimate this could add around £2.7bn to the deficit.
5. Cutting interest rates is therefore a costly option when looking at the student finance system as a whole and over the long-term. But that is of little comfort to a prospective student applying for probably their first loan of any kind and being faced with the SLC application portal highlighting the loan rate will be 6.3% while they study. The intangible 'cost' of this in terms of confidence in the system and its fairness cannot easily be quantified and the panel will need to consider carefully how that can be reconciled while ensuring other funding in the post-18 education system is not put at risk.

### How interest applies to student loans currently

6. Interest on student loans is accrued at the Retail Price Index (RPI) + 0 to 3% after graduation.<sup>2</sup> During study the rate is fixed at RPI+3%; an annual rate of 6.3% from September 2018. Reducing the interest rate applied to student loans has a number of key financial implications; it would:
  - shift more of the cost onto taxpayers, potentially creating more of a 50:50 split in terms of costs picked up by the individual and the Government (or rather the tax payer)
  - reduce average notional SLC debt on graduation and lifetime repayments so graduates (and particularly higher earners) pay back less in total
  - reduce the total number of loans written off at the end of the 30-year forgiveness period as loans are paid back more quickly (particularly by higher earners)
  - add to the deficit in almost every year between the loan being taken out and expiring as a result of the way in which student loan interest is treated in the Government accounts.
7. Clearly there are both pros and cons with lowering interest rates. Nevertheless, there remains an understandable public concern about SLC interest rates that are higher than for many other forms of borrowing (even if the other conditions attached to SLC loans may be more beneficial). In addition, the

<sup>1</sup> The Office for National Statistics is in the process of conducting a review on the treatment of student loans in the Government accounts. Whilst the outcome of the ONS review may affect the viability of the current system, this paper assumes the continuation of the current system for accounting tuition fee and maintenance loans.

<sup>2</sup> A taper based on earnings up to £41,000 determines the rate applied, with higher earners paying a higher rate

use of RPI as the measure of inflation for student loans has been widely criticised as it is no longer classified as a national statistic by the ONS. We have therefore modelled<sup>3</sup> how interest rates might be reduced, detailing the financial implications for students and the taxpayer, including:

- (a) moving to an interest rate based on the Consumer Price Index (CPI rather than RPI) as this is a more widely-respected measure of inflation and generally around 1 per cent lower on average<sup>4</sup>
- (b) moving to CPI and removing the application of real interest during study as a further means of reducing the effective interest rate as well as reducing loan debt on graduation<sup>5</sup>

Table 1: Financial implications of a reduction in the interest rate applied to student loans

Difference from current system:	Average notional debt on graduation reduced by...	Resource Accounting and Budgeting (RAB) charge <sup>6</sup> increased by...	Impact on deficit (negative values mean the deficit is increased)	Total economic cost	Average lifetime repayments reduced by...
Interest rate reduction of 1% (i.e. move to CPI)	£700	4.7 pp to 49.8%	£2,123m	£824m	Male: £3,900 Female: £1,400
Interest rate reduction of 1 per cent + removal of real interest rate during study	£2,800	6.0 pp to 51.1%	£2,665m	£1,037m	Male: £5,000 Female: £1,700

### Financial implications for Government

8. The cost to Government (and therefore for taxpayers) of lowering the interest rate could be substantial because of the way that Government accounting works. The RAB charge would be higher, meaning that around half of the initial loan outlay might not be repaid.
9. The total economic cost of moving to a system based on CPI would be around £824m per cohort, but it seems difficult to justify the continued use of RPI in the circumstances. In addition, a reduction in the interest rate would have a significant impact on the deficit: currently interest on SLC loans accrues annually as income, flattering the deficit regardless of whether or not it will ever be paid.
10. Given the economic cost and impact on the deficit, there is a risk that lowering the interest rate could therefore have knock-on effects for other HE budgets, or even on wider public spending. This could have wide-ranging consequences for the sustainability of the system and for students in terms of the quality of experience they can expect to receive. However, a change in the Government accounting rules may take some of the fiscal sting out an interest rate cut.

### Financial implications for students/graduates

11. Reducing the interest rate applied to student loans would reduce average notional SLC debt on graduation: by £700 for a 1 per cent reduction in interest and by £2,800 for a 1 per cent reduction plus the removal of real interest during study. Average lifetime repayments would also fall, principally because of a fall in the repayments of higher earners – lower earners would not stand to benefit. Men too would be likely to benefit more than women: a 1% reduction in the interest rate would mean men could expect to repay £3,900 less over the course of their lifetimes and women around £1,400 less, primarily due to the influence of gender pay gaps, although we expect these should narrow over time.

### Creating a new fairness balance

12. Lowering interest rates may help improve perceptions of fairness and affordability for students. However, it is difficult to put a value on something that revolves around confidence when this needs to be weighed against the real financial cost of an interest rate reduction. Under the current model, higher interest rates *technically* make the system more progressive: graduates with relatively higher earnings repay more, helping to cover some of the costs for lower-earning graduates who do not repay all of their loan. But this is often lost in the language of loans and debt.
13. Balancing the need to have a system that is recognised as progressive overall, while ensuring it is seen to be fair upfront to individuals is therefore one of the key challenges to address. Achieving this without necessitating damaging cuts to other budgets will be critical, so interest rate changes may need to be offset by other modifications to the SLC system.

<sup>3</sup> All cost modelling undertaken for the Russell Group by London Economics, 2018

<sup>4</sup> This would mean applying a rate of CPI+3% during study and CPI+ 0-3% after graduation depending on salary level

<sup>5</sup> Applying a rate of CPI+0% during study and CPI+ 0-3% after graduation depending on salary level

<sup>6</sup> The RAB charge is the estimated cost to Government of borrowing to support the student finance system (currently 45.1%).