

## Summary

The recent changes to how Britain finances undergraduate education are much more than a simple rise in the fees charged to students. The repayment system has become much more progressive. In particular, students no longer have to start paying anything back when their earnings reach £15,000, but instead do not start repayments until their income exceeds £21,000. In addition, those on higher earnings will pay a higher rate of interest. This is designed to make system more progressive.

In that context, the government is concerned that those on high incomes can avoid paying the higher rate of interest, by repaying their loan earlier. For that reason it is considering introducing a system of early repayment charges for those on high incomes, or those making large repayments, or both.

We argue that this is not the appropriate response. Most early repayments are small, and made by relatively poor graduates. Debt aversion, not affluence, is the biggest cause of early repayments. A system of penalties for affluent people repaying will therefore create another complexity while covering only a minority of loans. Furthermore, even affluent graduates pay a price when they repay their loan, in that they surrender the right to have the loan written off if their circumstances change. That becomes more important as the average size of loan increases.

Finally, the trajectory of graduate incomes, and the complex nature of the loan repayment system makes it impossible to calibrate an individual repayment charge in any sensible way.

## Introduction: the issue

The government is consulting about placing a repayment penalty on former students who pay off some, or all, of their student loans ahead of schedule. The stated rationale is to ensure that the system is progressive. To quote the consultation: "We are committed to the progressive nature of the repayment mechanism. It is therefore important that those on the highest incomes after graduation are not able unfairly to buy themselves out of this progressive mechanism by paying off their loans early. That is why we are consulting on potential early repayment mechanisms – similar to those paid by people who pre-pay their mortgages."

The government is considering two distinct options:

# Early repayment of student loans: should government impose early repayment penalties?

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- (1) early redemption penalties for high earners.
- (2) early redemption penalties for large repayments.

It is also possible to imagine the creation of a hybrid system of these two options.

This note considers the arguments for and against early redemption penalties.

## Background – understanding the loan repayment system.

Student loans are repaid on an income contingent basis. Someone who has incurred a loan will repay at a rate of 9% of their income above £21,000. Interest is added at the rate of inflation (measured by RPI) plus up to 3%, with the interest rate varying according to the former student's income. Any amounts outstanding are written off after 30 years.

The coalition was at pains to make the new repayment system more progressive than the previous one. This is the reason why the interest rate is related to earnings, and also why repayments now start at £21,000, rather than £15,000.

As we noted, the interest rate charged on the loans is income related. The system is set out in EBCC/2011/Note 18, “Memorandum submitted by the Department for Business, Innovation and Skills to the Public Bill Committee on clause 70 and 71 (e 107).”<sup>1</sup> This states that “For those earning £21,000 or less, the rate of interest will be RPI only. For those earning more than £21,000 and up to and including £41,000 the interest will increase on a gradual scale between RPI and RPI + 3%. Interest will apply at RPI + 3% for those who earn more than £41,000.”

Although this interest rate surcharge is designed to be progressive, it is worth noting that the real interest surcharge is not progressive over all income levels. It is true to say that someone earning £41,000 pays a higher rate of interest than is paid by someone earning £31,000. It is also true to say that they pay more in total, and pay a higher interest rate surcharge in total. In this instance the system is clearly progressive. In contrast, people earning more than £41,000 all pay the same interest rate, and within this group the lower paid take longer to repay the debt. This means that they will pay a higher total surcharge than people with higher earnings. For example, and assuming constant earnings over time, someone on £51,000 pays half the total interest surcharge of someone on £41,000, at £11,300 and £21,700 respectively. In this instance the system is clearly not progressive.

## Arguments in favour of an early repayment charge

### 1) It is progressive

The argument in favour of early redemption penalties is simple: those who repay early are likely to be richer, and will, therefore, be escaping the 3% real interest surcharge. They should not be allowed to do this, hence the need for an early repayment surcharge.

## Arguments against an early repayment charge

### 1) Philosophical

There is a philosophical argument against an early redemption penalty on student loans. Student loans are supposed to be a debt, voluntarily incurred by students, to pay for the

cost of their tuition. As such there is an amount outstanding that needs to be repaid. Charging an early repayment penalty on the grounds that such a charge is progressive muddies the waters as to whether the system is a loan or a tax. If it is a loan, then an early repayment charge on the grounds of progressivity makes no sense. (It is worth noting in this context that the 3% interest rate surcharge is also hard to defend). If the government wishes to be more progressive, they should move to a system of a graduate tax, in which graduates simply pay a proportion of their earnings for life. There would then be no option to repay the debt early, and no issue of whether those doing so were failing to pay their fair share. But equally a graduate tax means that it would be possible to repay the cost of an education many times over: there would be no connection between the amount that the degree cost to provide, and the amount that the graduate paid. Furthermore, moving to a graduate tax would eliminate any possibility of price competition between universities.

### 2) Early repayments do not demonstrate high incomes

At first sight we would expect it to be the case that it is rich people who pay off their loans early. This is not currently the case. The median income of those making additional repayments under the current system is £18,400, and the median repayment is £900.<sup>2</sup> Thus we find that the typical person making an additional repayment has an income so low that they will no longer be required to repay any money whatsoever, and that the size of a typical repayment is low. This means that if current patterns of repayment continue, the majority of repayments will not be covered by an early redemption penalty.

People making early repayments are also young – on average 25 years old. It is possible that a 25 year old earning £18,400 has just inherited a fortune, or that they have rich parents. No doubt there are examples of this. But it is more likely that these are people who are simply debt averse, and wish to pay off their loans as and when they can, whether or not it makes sense in narrow financial terms. Given the sorts of people who choose to repay money early, an early repayment charge would be a tax on debt aversion as much as anything. If there is to be a penalty on repayment, it is important to allow this group of people to make repayments without charge. That would point to a relatively high threshold before any penalty is imposed.

<sup>1</sup> [www.publications.parliament.uk/pa/cm201011/cmpublic/education/memo/e107.htm](http://www.publications.parliament.uk/pa/cm201011/cmpublic/education/memo/e107.htm)

<sup>2</sup> [www.bis.gov.uk/assets/biscore/higher-education/docs/c/11-1047-consultation-on-early-repayment-student-loans.pdf](http://www.bis.gov.uk/assets/biscore/higher-education/docs/c/11-1047-consultation-on-early-repayment-student-loans.pdf)

### 3) It would be hard to calibrate

We have already seen how the real interest rate premium affects people on different incomes in dramatically different ways. Without knowing someone's future income stream it would not be possible to calibrate the early repayment charge in such a way as to capture the future real interest charges.

Nor can we imagine that we would want to. Someone earning £41,000 a year will pay around £21,700 in total real interest charges over their 30 years, on a base debt of £38,250.<sup>3</sup> It is not possible to imagine that the government would want to charge that person a 57% early repayment charge on any repayments made in the first year, on the grounds that this is the amount the person will be saving later on.

It is equally difficult to imagine that the government would want to charge someone earning £41,000 a repayment penalty double that charged to someone earning £51,000, on the grounds that this accurately reflected future savings to the individuals concerned.

For these reasons it is simply not possible to create a system whereby "those on the highest incomes after graduation are not able unfairly to buy themselves out of this progressive mechanism by paying off their loans early." The interactions between having repayments related to incomes, the interest rate system, and the debt write off after thirty years means that it is not possible to calibrate an individual early repayment mechanism that means no-one is advantaged by making early repayments.

### 4) There are already penalties for early repayments

At present unlimited repayments are allowed without any apparent penalty. They are made "at par" so to speak. Yet graduates who make early repayments are paying a number of penalties, albeit disguised ones. This comes from the contingent nature of the loan system.

The first penalty paid by those who repay early is giving up the "life insurance element" that is part of the student loan system. If you die, the debt is written off. If you die after making an early repayment, you don't get the early repayment back. ONS data show that 21 year olds males and females respectively have a 4.6% and 2.7% chance of dying in the subsequent 30 years.<sup>4</sup> The figure is substantially higher for mature students. Graduates may well have lower mortality rates (reduced rates of smoking, working

in dangerous occupations, etc), and not all repayments occur at 21. Nevertheless, it is plausible that the state will typically gain at least 1% of the amount repaid early, in the form of not having to write off some of that amount in the event of death. Someone making an early repayment therefore makes a de facto "early repayment charge" of around 1%.

The second penalty paid by those who repay early is giving up the "income contingent loan write off". If your income is insufficient, the loan is forgiven after 30 years. Given the way in which fees have risen, many people are likely to fall into that category. A graduate needs an income equivalent to £42,750 a year, for 30 years, to repay all of their debt under the current system.<sup>5</sup> People who pay off now are giving up what is quite a valuable asset – the right to have their loan written off should their income fall below this level. Given that the average person making a voluntary early repayment currently is 25, and earns just £18,400 a year, it is likely that many of these people are repaying money that they would not end up repaying at all, under the standard loan system. They are, in short, making large voluntary tax payments. In many cases these payments will not reduce future loan repayments at all – someone earning £30,000 a year, in perpetuity, and with the maximum loan, will not reduce future payments at all if they repay 10% of their debt on graduation. Every penny of their early repayment is a gift to the government.

This is particularly important for female graduates, who are much more likely to have a career break, or to work part time. Combined with lower rates of pay per hour, this makes them much more likely to benefit from the income contingent loan write off.

### 5) Early repayments save the government money

There is a cost to government of running the SLC. Earlier payers therefore directly reduce the costs on government. The SLC also loses some people through administrative error. It is costly to find them, and costly not to find them, in that they make no further repayments. Early payers reduce these costs to government. In addition, early repayments reduce the government's borrowing requirement, and insofar as the interest rate that the government has to pay is related to the borrowing requirement, early repayments reduce the interest rate government has to pay on borrowing.

<sup>3</sup> Assumes £9,000 a year in fees plus £3,750 in maintenance, for three years. Some universities will charge less.

<sup>4</sup> [www.statistics.gov.uk/downloads/theme\\_population/Interim\\_Life/ilteng-reg.xls](http://www.statistics.gov.uk/downloads/theme_population/Interim_Life/ilteng-reg.xls)

<sup>5</sup> Assumes £9,000 a year in fees plus £3,750 in maintenance, for three years. Some universities will charge less.

### 6) Early repayments reduce likely losses if the government sells off the student loan book

From time to time the government considers auctioning the student loan book. Given the income contingent nature of the loans, the book will sell for far below par value. Having students repay at par therefore reduces later losses compared with selling the same loan for below par value later on.

### 7) Government does not profit from the progressive interest rate surcharge

People earning more than £41,000 pay interest at a rate of inflation plus 3%. This does not mean, however, that government makes a profit from these people on the loans that it is making. Although it is currently possible for the government to borrow money at exceptionally low rates, Professor Nick Barr's evidence to the Browne Review demonstrated that the government's cost of borrowing is typically around 3% in real terms. From the government's point of view, therefore, there is no advantage to having even affluent students take longer to repay their loans – and as such, there is no foregone profit when such students make early repayments.

### 8) The comparison with mortgages is not a good one

There are two reasons why this comparison is not valid. First, not all mortgages have early redemption penalties. Those who are subject to them have chosen to take out mortgages that have early redemption penalties. Second, there are two conditions under which mortgage early repayment charges apply. The first is when the mortgage had no up front fees, and the lender paid for the valuation, legal fees, and so on. Under these circumstances the early repayment charge is best seen as a way to prevent the lender making losses on people seeking short term secured loans. The second type of mortgages with early repayment penalties are those with fixed interest rates. Here the early repayment penalties reflect the fact that the lender has usually arranged fixed term borrowing of its own, to support the fixed term lending. Were there to be no repayment penalties borrowers would face a one way bet: if interest rates fell, they would remortgage and repay, if interest rates rose, then they would not. Even in these circumstances lenders usually allow some

amount to be repaid, often 10% of the original amount per year.

Early repayment penalties on mortgages are usually small – typically in the low single digit percentages – say 2%, or 5% at most. These would be small compared to the lifetime real interest premium for anyone earning over £21,000. Even someone earning £22,500 will repay 6.6% of the amount outstanding in real interest over the 30 years. A mortgage style early repayment penalty will not act as a meaningful disincentive to making repayments. Nor will it ensure that the most successful graduates make the same total financial contribution as they would otherwise be obliged to make.

### 9) The sums raised would be small relative to the costs

Currently, the median repayment is £900, and the median person repaying earns £18,400. This means that, if current patterns of repayment persist, the majority of repayments will not be covered by an early repayment scheme that applies only to high earners making repayments, or to those making large repayments. For that reason an early repayment charge is likely to raise very limited sums for the government, while adding a new layer of complexity and 'red tape'.

### 10) The very rich bypass the system entirely

We know that many rich people bypass the student loan system in its entirety. They simply pay the fees upfront. For that reason even a self-styled progressive early repayment charge will not be successful in charging people from the richest backgrounds.

## Conclusion

The government should not proceed with plans for early redemption penalties for student loans. Such plans would clearly add complexity and cost, and would raise little revenue. It is not clear whether such a penalty would prove progressive or not – the typical person making a repayment currently has an income below the average for the UK as a whole, let alone the UK graduate average. Finally, even without an explicit early repayment penalty, those making early repayments pay a cost in any case, in that they give up the rights to have the loan forgiven if their circumstances change, and give up the right to borrow money at exceptionally low rates.