HOUSE OF COMMONS LIBRARY

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Student loan interest rates FAQs

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Student loan interest rates FAQs

On 1 October 2017 the Prime Minister announced that there would be changes to the student finance system: the fee cap would be frozen at £9,250, the repayment threshold would rise to £25,000 and a there would be a review of the student finance system. **These changes are not included in this briefing's analysis**. They will be incorporated when more detail is announced.

In September 2012 the Government made significant changes to the student finance system which included: allowing universities to raise their fees to £9,000 per year, raising the repayment threshold on student loan repayments to £21,000 and introducing a new variable tiered rate of interest on student loans.

At the time the changes were introduced the main focus of debate was on the increased level of tuition fees – very little was said about the new interest rate system.

Under the new system the interest charged on loans varies over the life of the loan – while studying the interest rate added is RPI + 3%, when a student graduates and is earning under the income threshold the interest rate falls to RPI and when a student is earning over the threshold the interest rate starts at RPI and rises to RPI + 3% when a graduate is earning over £41,000 per year. The intention of the scheme was to make repayments more progressive so that graduates earning more would repay more. The system was criticised by the Institute for Fiscal Studies for being complicated.

Since the introduction of the scheme the Government has made several more significant changes to the student finance system, such as the abolition of maintenance grants, which have moved student funding increasingly away from non-repayable grants and bursaries towards repayable loans. These changes have increased the amount of debt accrued by students.

The first large cohort of borrowers who took out loans under the new system became liable to repay these in April 2016. Since then debate has increased about the interest charged on loans. Additionally in April 2017 it was announced that the interest rate on loans for 2017/18 would be 6.1%. These factors have escalated debate around the interest rate on student loans – particularly around the rationale for the high levels of interest on student loans in a time of generally low interest rates.

In September 2017 there was speculation in the media that the interest rates on loans might be cut and on 12 September 2017 the Chancellor of the Exchequer gave evidence to a House of Lords Select Committee in which he said that the Government were looking into student funding and interest rates on student loans.

Nothing further has been announced on interest rates but on 4 October 2017 the Prime Minister announced a major review of university funding and student finance.

1. What is the interest rate on student loans in England?

In England there are two types of income contingent student loans:

- **Plan 1 loans** are loans taken out before September 2012
- **Plan 2 loans** are loans taken out on, or after September 2012.

Different interest rates apply to each type of loan.

Information on student loans interest rates is on the Student Loans Company website at Changes to interest rates and thresholds.

Plan 2 loans

The interest rate on these loans is currently between **3.1%** and a maximum of **6.1%.**

The interest rate charged varies depending on the student's circumstances:

- while studying and until the April after leaving the course students accrue interest at **RPI + 3%,**
- when a student has graduated and is under the repayment threshold the interest rate is **RPI**
- when a student is earning over the threshold the interest rate is **variable** dependent upon income - RPI (3.1%) where income is £21,000 or less, rising on a sliding scale up to RPI + 3% (6.1%), where income is £41,000 or more.

Plan 1 loans

The rate on these loans is **1.25%.**

1.1 What is the reason for the current system of interest rates on loans?

The current interest rate system was introduced following an independent review of student finance – the Browne Review.

The variable tiered interest for Plan 2 loans was designed to be **more progressive** than the old system so that the highest earning graduates would repay more than the lowest earners. The benefits of the system were set out in a PQ on 12 September 2017 (HC Deb 12 September 2017):

> **Michael Tomlinson**: 04 September 2017
>
> To ask the Secretary of State for Education, for what reasons interest rates on student loans are set at their present level; and what the potential merits are of lowering those levels.
>
> **Joseph Johnson** : 12 September 2017
>
> The interest rates for income contingent student loans are prescribed by secondary legislation. The rates for all three schemes are set annually and apply from 1 September to 31 August the

> following year. The rates are based on the retail price index (RPI) from the previous March.
>
> Interest rates for student loans in repayment vary with the income of the borrower. Borrowers earning less than £21,000 p.a. are charged interest at RPI only. Interest then increases on a sliding scale with income up to a maximum of RPI+3% for borrowers earning over £41,000.
>
> Government-issued student loans have much more favourable terms than commercial loans, and are subsidised by the Government. Borrowers are protected. Monthly repayments are linked to income and not to the amount borrowed. Borrowers earning less than the repayment threshold of £21,000 repay nothing at all. Borrowers earning above £21,000 repay 9% of their income above the threshold, irrespective of the amount borrowed. Any outstanding loan balance, including interest, is written off after 30 years with no detriment to the borrower. Student loans are available to all eligible students regardless of their previous financial history. The Department is not aware of any commercial loans that offer this level of borrower protection.
>
> This system of variable interest rates based on income is progressive, and ensures that higher earners make a fair contribution to the sustainability of the higher education system. Reducing interest rates would only benefit higher earning borrowers, who would pay back less than they do currently. Low-earning borrowers, who will have a proportion of their debt written off at the end of the loan period, would not benefit from a reduction in rates.

The system was criticised however in a 2010 briefing note by the Institute for Fiscal Studies for being complicated:

> The new system is less transparent than the current system and that proposed by Lord Browne, with a more complex system of student support and interest rates.[1]

1.2 How and when is the interest rate decided?

The interest rate is **set by the Department for Education (DfE) each year**. The interest rate is updated once a year in September, using the change in the RPI in the year to the previous March. So the RPI element for academic year 2017/18 is based on the RPI in the year to March 2017 which was 3.1%.

1.3 Has interest always been charged on student loans?

The first mortgage-style student loans were introduced in 1990 under the *Education (Student Loans) Regulations 1990* SI No 1401. Regulation 6 stated that interest was payable on loans and that the rate would be set by the Secretary of State:

[1] Institute for Fiscal Studies, Briefing Note (BN113) *Higher education reforms: progressive but complicated with an unwelcome incentive*, 8 December 2010

> **Interest**
>
> **6.—(1)** Loans shall bear interest at the percentage per annum specified in paragraph (2) being the rate appearing to the Secretary of State to be requisite for maintaining the value of the amount of the loans in real terms.
>
> **(2)** That percentage is the percentage increase between the retail prices index published by the Central Statistical Office of the Chancellor of the Exchequer for June 1989 and the retail prices index so published for June 1990.

At the time of the introduction of student loans a Department for Education and Science publication - *Top up Loans For Students. The Government's Proposals* stated that a 'real interest rate of zero' was payable on loans:

> **Repaying the Loans**
>
> **What will be the terms of the loans?**
>
> Loans will be offered at a *real* interest rate of zero. That means that the value of what the borrower pays back will be the same in real terms as the value of the sum borrowed. To achieve this, the individual's outstanding debt will be adjusted annually in line with the Retail Price Index. There will be no additional interest payments.
>
> The amount to be repaid will continue to be adjusted in this way during any period of deferment

The use of the phrase 'zero real rate of interest' led some people to think that interest was not charged on loans whereas what this meant was that interest would be charged at RPI and no higher.

The *Education Act 2011* s76 now allows the charging of a real rate of interest on student loans.

1.4 When does interest begin to accrue?

Interest is charged on loans **from the day the first payment is made** until the loan is repaid in full. Interest is added to the total amount owed every month.

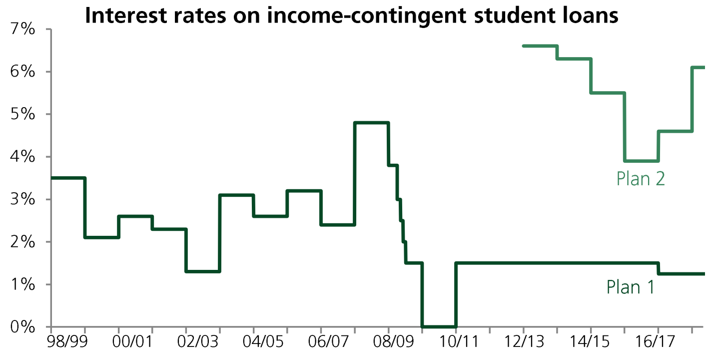
2. Why do some borrowers get charged a lower rate?

The Plan 2 rate varies according to a graduate's earnings. The lower rate is based on the UK Retail Price Index (RPI) and applies to graduates who are not earning or are earning below the level where they need to make repayments. This is currently £21,000. The maximum is set at RPI +3% and applies to current students and graduates earning above the upper earnings threshold; currently £41,000.

The Plan 1 rate was set at RPI+0%, however it was introduced under legislation that required that interest rates for these loans should not exceed one percentage point above the highest base rate of a specified group of major banks. The so-called '**low interest cap'**. This cap has applied for many years now.

2.1 How have these rates varied over time?

Variations in the interest rates on income contingent loans are illustrated opposite.



Pre-2012 (Plan 1)

The interest rate in 2007/08 was 4.8%, the level of all-items RPI inflation in financial year 2006-07. This was the highest annual rate since 1991/92.[2] The rate for 2008/09 was initially set at 3.8% reflecting the fall in inflation in 2007-08. The subsequent large falls in Bank of England base rates meant that the low interest cap was used for the first time. The interest rate on income contingent loans was reduced in stages to 1.5% during the year. Interest rates were only lower in 1993/94 and 2002/03.[3] [4] [5]

The all-items RPI was -0.4% in the year to March 2009. The (then) current regulations stated that *if* an interest rate is to apply to these loans then this will be the rate for the year from 1 September 2009.[6] In the past the then Government stated that it had 'no plans to abandon the consistent use of RPI in calculating interest on student loans'.[7] It subsequently decided that no interest rate (0%) was to apply to income contingent student loans in 2009/10. The small numbers of remaining mortgage-style loans were solely linked to RPI and hence their interest rate was -0.4%.[8]

2 Facts & Figures, Student Loans Company http://www.slc.co.uk/statistics/facts_figures.html
3 ibid.
4 HC Deb 26 January 2009 c268W
5 *Income Contingent Loans (ICL) - Maximum Loan Rates*, SLC
6 *The Education (Student Loans) (Repayment) Regulations 2009*, (SI 470 2009) : http://www.opsi.gov.uk/si/si2009/uksi_20090470_en_3#pt2-l1g21
7 HC Deb 9 July 2008 c1716W
8 Student Loans Company Repayment site, *Interest rate for Income Contingent Loans,*

Having no interest on student loans does not affect monthly repayments of those with outstanding income contingent loans. Repayments are based on income, not the interest rate. The cut to 0% would slightly reduce the loan period/total repayments for those who completely paid off their loans in year, but this applies to *any* cut in interest payments. The impact on other borrowers will depend on how interest rates on student loans and hence RPI vary in future years. If inflation jumps up to above the long-term trend then any advantage they might have gained would be lost.[9] This effect could be reduced by the continued operation of the low interest cap.

The rate for income contingent loans depends on whether the low interest cap still applies and hence on decisions by the Monetary Policy Committee of the Bank of England. These were cut further to 0.25% in August 2016 and therefore interest rates on Plan 1 loans is now 1.25%. Any further changes to base rates during would normally mean immediate changes in the student loan interest rate. Such variations potentially change the *duration* of the loan, not the monthly repayments which depend on income.

Post 2012 loans (Plan 2)

With no 'low interest rate cap' and rates set at RPI +3% the Plan 2 interest rates have been much higher: 6.6% in 2012/13, 6.3% in 2013/14, 5.5% in 2014/15, 3.9% in 2015/16, 4.6% in 2016/17 and 6.1% in 2017/18.

http://www.studentloanrepayment.co.uk/portal/page?_pageid=93,3866911&_dad=portal&_schema=PORTAL

9 If the current negative inflation rate is simply a blip then any gain in 2009/10 will be lost for those who repay in later years. If there is no steep upward increase in prices after the period of deflation, but a direct return to long term levels of inflation, then all who eventually repay their loans would gain compared to steady trend inflation/interest rates.

3. How do rates vary within the UK?

Students living in Wales have the same interest rates and loan repayment plans as students living in England.

Students living in Scotland[10] and Northern Ireland[11] repay their loans under the Plan 1 system so students accrue interest and repay in the same way as English students with Plan 1 loans.

10 Students Awards Agency Scotland, Repaying the student loan
11 Student Finance NI, *Terms and Conditions 2016/17 Student Loans A guide to terms and conditions* p6

4. How does the post-2012 rate vary by income?

The maximum interest rate of RPI+3% is charged on all loans while the borrower is studying and until the April after they complete their course (the statutory repayment date). From then on the rate is based on their income: RPI+0% for incomes at or below the lower repayment threshold (£21,000) increasing on a sliding scale to RPI+3% at and above the upper repayment threshold (£41,000). This is illustrated opposite. The variable rate means that any graduate making repayments will see their outstanding debt fall in real terms.

These thresholds have been frozen at their April 2016 levels until at least April 2021. Readers can find more detail on this and its potential impact on different groups of graduates in library briefing: *Freezing the student loan repayment threshold*, 15 July 2016.

5. Why is the interest rate linked to RPI rather than CPI or some other index?

The first student loans were introduced under the *Education (Student Loans) Regulations 1990* SI No 1401. Regulation 6 stated that loans would bear interest based on RPI. RPI has therefore been used ever since as the measure of inflation for calculating the rate of interest on student loans.

A rationale for the use of RPI rather than CPI was given in a Department for Education answer to an FOI request - Use of RPI in student loans and positive real rate of interest- on 27 July 2017

> RPI has been used as the basis for calculating the interest rates applied to income-contingent repayment student loans since they were introduced in 1998 and there are no plans to change this. There is no single measure of inflation that is appropriate for all purposes. RPI is still commonly used in private contracts for uprating of maintenance payments and housing rents.
>
> We have always taken the view that RPI is more appropriate than the Consumer Price Index (CPI) for student loans as it takes account of, amongst other things, changes in mortgage interest payments and council tax (typical expenses for graduates which are not included in calculation of the CPI). Historically, RPI has always been used for calculating interest on student loans. This means that over the period of years, the rate of interest on student loans has been consistently linked to a widely recognised and adopted measure of inflation.
>
> The department regularly monitors the interest rates set on student loans against the interest rates prevailing on the market. The most appropriate comparators for undergraduate student loans are the effective interest rates available on unsecured personal loans, as published by the Bank of England (data series CFMBJ77 and CFMBJ94). Both rates continue to be above the maximum interest rate charged on student loans.

This issue has been raised in Parliament – below is a House of Lords PQ on the issue 6 June 2016:

> **Lord Myners:** 6 June 2016
>
> HL427
>
> To ask Her Majesty's Government whether they will consider linking the interest rate on student loans to the Consumer Price Index rather than the Retail Price Index.
>
> **Baroness Neville-Rolfe**:16 June 2016
>
> The Government has no plans to link the interest rate on student loans to the Consumer Prices Index, rather than the Retail Prices Index. The Retail Prices Index has been used as the basis for calculating the interest rates applied to income-contingent student loans since they were introduced in 1998.

6. Why do we need an interest rate on loans at all?

Charging a real interest rate on loans removes part of loan subsidy and hence makes offering each £1 of loan cheaper for the public sector. Alternatively a real interest rate means a greater total amount can be lent to students with the same amount of public subsidy.

If no real interest rate was charged on loans then one or more of the following would need to happen.

1 Public expenditure on higher education increases

2 Reduced student loan amounts either through

  a. Cuts in student numbers

  b. Reduction in maintenance support

  c. Reduction in fee loans (lower level of fee cap)

3 Changes to other aspects of student loan repayment terms

Each 'option' has different groups of winners and losers and hence potential trade-offs.

1) Could be funded by cuts elsewhere, higher general taxation or a specific tax on graduates.

2a) would have a negative impact on some potential students, reduce university income and could reduce economic growth in the longer term. 2b) could, depending on how it was implemented, particularly affect potential students from lower income groups. 2c) would reduce university income and could potentially affect the quality of undergraduate education and/or their efforts to widen participation.

The cost of option 3) would be felt by graduates. Lowering repayment thresholds would see this cost fall disproportionately on lower and middle earners. Increasing the term of the loan would put the cost on middle earners as would increasing the repayment rate.

7. Are interest rates in England higher than those in the rest of the world?

The OECD has made some comparisons of different aspects of student loans. The most recent ones that include interest rates mainly cover arrangements in 2014/15. The complexity of loan systems in many countries means that direct comparisons are not straightforward. Full detail can be found here (indicator B5). In general UK (English system) interest rates on loans were somewhat higher than typical rates. The annual average loan amount was higher than that in any other country with data on the subject, as was the proportion of students taking out loans. Annual income repayment thresholds (where they exist) are generally lower elsewhere than the income contingent threshold for the UK.

Student loan systems vary greatly across the world and a single interest rate, or even a range of rates may not fully illustrate the 'cost' of the scheme to graduates or the public sector. This also depends on the scale of the loans system, other repayment terms and how and when loans are written-off.

The latest OECD analysis of student loan terms give some comparisons of different aspects of systems in its member countries, but not interest rates.

8. Which graduates will benefit from a cut in interest rates?

The following groups of graduates/borrowers would benefit if interest rates were reduced:

- **Those who would repay their loans in full under the current interest rates**. These are, broadly speaking, higher earning graduates
- **Those who would not repay their loans in full under current rates, but would do so with lower rates.** These would be expected to be middle earning graduates, the precise distribution depends on the size of any reduction in rates and their loan amounts.

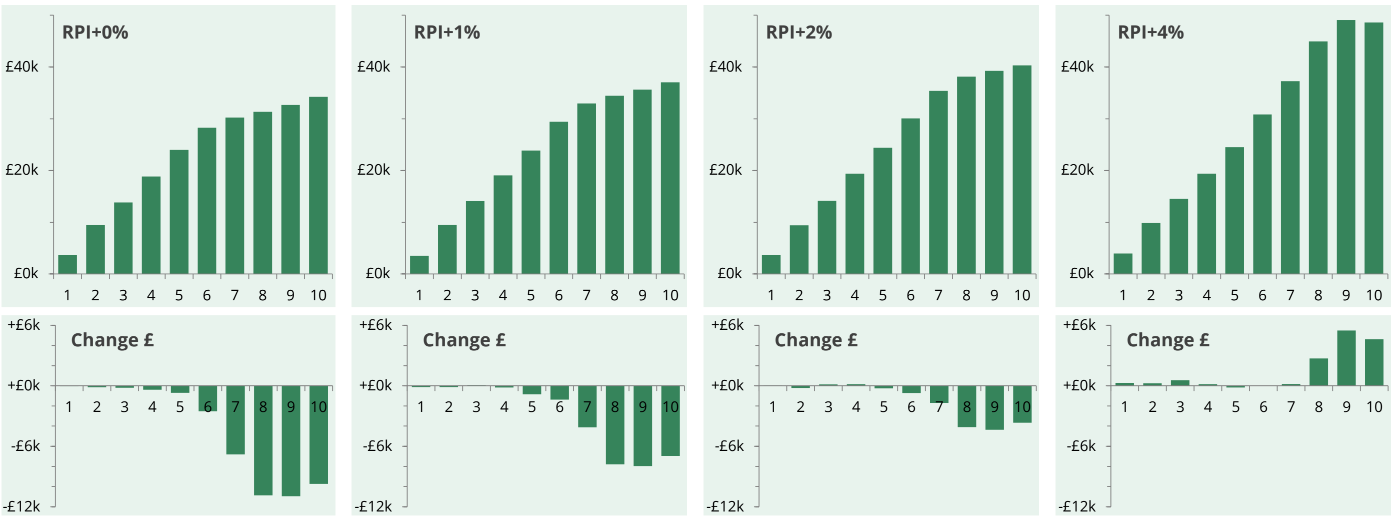
The group which would not benefit from a lower rate is:

- **Graduates who would not repay their loan in full even with a lower rate.** These are lower earning graduates and, again, the precise distribution depends on the size of any rate reduction and loan amounts. This is regardless of whether they make any repayments or not. Their repayments depend on their income and the repayment threshold alone, not interest rates.

The charts below look at repayments by income decile of graduates[12] under different maximum interest rates.[13] The first chart gives lifetime repayments in present value (discounted) terms and the one below the change compared to the current maximum. Where the change is positive this group would repay more and where it is negative they repay less or benefit from the change. These charts illustrate the point made earlier that it is higher earning graduates, particularly those in the top three deciles, who would benefit from a cut in the maximum interest rate.

HIGHER EARNING GRADUATES BENEFIT MOST FROM A CUT IN INTEREST RATES

Present value of repayments by 'lifetime' income decile of graduates



[12] From lowest lifetime income to highest

[13] The data are from the latest public version of the Government's [Student loan repayment model](). This was published in before the Summer Budget 2015 changes to student finance were announced. The model has been adapted where possible to reflect these changes, but its underlying assumptions about earnings and employment have not been changed and it takes no account of variations in loan amount by income caused by the ending of grants.

9. Will interest rate change if student loans are sold?

On 6 February 2017 the Government announced in a written statement, Government Assets Sale, that it planned to sell off loans taken out between 2002 and 2006.

The Government has stated on several occasions that students and graduates with outstanding loans **should not be affected by any sale of loans,** this was re-stated by the Minister in answer to a PQ on 10 July 2017:

> **Angela Rayner** on 04 July 2017
>
> To ask the Secretary of State for Education, whether it is her policy to privatise the student loan book; and if she will make a statement.
>
> **Joseph Johnson** on 10 July 2017
>
> The process required to sell part of the English student loan book under the Sale of Student Loans Act (2008) was launched in February this year. An update will be provided in due course.
>
> A sale on the basis set out in February would not represent a step towards privatisation of the provision or administration of student loans. The position of people with student loans would not be affected as a result of such a sale.
>
> The proposed sale comprised the rights to future repayments and would not involve alteration of the mechanisms or terms of repayment.
>
> This sale process was the first in a planned programme of sales of loans issued under the previous "pre-2012" system, targeting £12bn of proceeds by the end of the 2020-21 financial year.

The PQ suggests that a sale is still intended but that no date has been set.

For further information see the following library Briefing Papers:

- *Student loan statistics*, 21 June 2017
- *Freezing the student loan repayment threshold*, 15 July 2017
- *Higher education funding in England*, 14 July 2017

10. What has caused the current debate on interest rates?

The changes to the repayment threshold and interest rate were brought in under the *Education (Student Loans) (Repayment) (Amendment) (No. 2) Regulations 2012*, which came into force on 18 June 2012.

The first Plan 2 loans taken out by students came into repayment status in April 2016. The debate on the rate of interest charged on student loans really began from this point when students received their student loan statements and became fully aware of the interest charged on their loans.

All students taking out loans are advised to read a Student Loans Company publication Student Loans Terms and Conditions[14] where interest rates charges are clearly set out.

The interest rate issue received more attention in 2017 when it was announced that the rate applied to student loans in 2017/18 would be 6.1% - this was a large increase from the 2016/17 level of 4.6%.

A report by the Institute for Fiscal Studies, *Higher Education funding in England: past, present and options for the future* July 2017 stated that under the 2012 system students from the poorest 40% of families would **accrue around £6,500 in interest during study**. The report also said that the interest rate had **virtually no impact on the repayments** of the lowest earning graduates because very few would earn enough to repay the interest accrued. The interest rate would however have a significant impact on top earners.

[14] Student Loans Company, *Student loans - a guide to terms and conditions 2016/17*

11. Will the Government review interest rates on student loans?

On 12 September 2017 the Chancellor of the Exchequer gave evidence to the House of Lords Select Committee on Economic Affairs in which he said that the Government were looking into student funding and interest rates on student loans:

> The interest rate charged on a student loan is not like the interest rate charged on a commercial loan from a bank. This is a loan, the repayment of which is income-contingent. We know at the outset, by design, that a significant proportion of loans will not be repaid. When we know that the loan will not be repaid, the interest added to it is, in a sense, notional. It will not be repaid if the borrower turns out to be a low-income graduate.
>
> By design, the system has an element of transfer, a redistribution from higher-income graduates to lower-income graduates. That was how the system was always intended to operate. As I said at the beginning, I recognise that questions have been raised about the overall proposition, and we are looking carefully at how it works to make sure that the way it operates is justifiable.[15]

[15] House of Lords, Select Committee on Economic Affairs Corrected oral evidence: Chancellor of the Exchequer annual evidence session 12 September 2017 Q1

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