LEXINGTON
WEALTH MANAGEMENT

STUDENT LOANS
YES? OR NO?

A common objective for wealthy parents is to help their children fund a university education but, at a cost of £9,250 per annum before you've even bought a single textbook, Pot Noodle or any accommodation, the cost is far from trivial.

Almost everyone has a 'wish list' which costs more to fulfil than the assets they have available – repay the mortgage, retire early, family holidays etc. – and this is where we come in: we add value by helping our clients to prioritise their objectives and optimise resources to fulfil as many desires as possible.

If you are thinking of helping your children with the cost of university, part of our job is to help establish if that is a good use of your wealth given everything else in your life. For anyone short on time, the 'TLDNR' is you should probably keep your cash and use a student loan.

Although this guide assumes you're a parent thinking of your child's university education, the points apply to anyone considering how best to finance a degree. I should also point out all references to student loans here refer to the post-2023 Plan 5 system, i.e. the one open to applicants from August 2023.

Furthermore, I focus on the cold hard finances, but some will have other considerations such as personal values and religious beliefs. For most graduates, the taxpayer will end up repaying a good chunk of their loan, and some would think dimly of burdening the state unnecessarily with an education if you could afford to fund it yourself. As for religion, I am no specialist but some religions have strict rules forbidding the borrowing of money and/or the payment of interest; student loans are apparently not Sharia compliant, for example.

How do student loans work?

Let's start with a brief overview of how student loans work:

- There are loans to cover tuition fees, and loans to help cover maintenance and accommodation costs – the former is up to £9,250 per annum (to equal the cap on tuition fees), and the amount for the latter depends on household income and where the student will live whilst studying.
- Interest is applied at the RPI inflation rate for loans from August 2023.
- Repayments start in the April after leaving University (but only for those earning above the repayment threshold, which is £25,000 for 2023/24).
- Repayments stop on the earlier of death, repayment of the loan, or 40 years from the April after graduation.

The interest rate changes every September and the inflation figure used is RPI as at the March prior, however, the current interest rate is 6.5% after the Government's intervention in response to the ongoing high rates of inflation.

False Advertising

For many (myself included), the phrase 'student loan' is problematic as the 'loan' works far more like a tax than a debt.

You may question the value of arguing semantics, but framing this as debt can conjure strong emotional responses in some, and strong emotions are not conducive to rational financial decisions. It is sad to think some spend great effort (and money) trying to repay student loans because they misunderstand the workings and wrongly conclude it will improve their finances.

A highlight of some key differences for students

Student Question	Normal Debt (mortgages, loans, credit cards)	Student Loan
How are the repayments calculated?	Calculated according to amount owed and the timespan of the loan	9% of earnings over the repayment threshold (£25,000 for 2023/24)
What if you have low earnings?	Nothing changes – monthly payments must be maintained	If you earn less than the repayment threshold (i.e. £25,000 for 2023/24), you pay nothing
What if you stop earning?	You must still maintain monthly the payments	You stop repayments until you are earning enough again
What might happen if you can't afford the repayments?	Arrears, legal enforcement, damaged credit score, bankruptcy and, for mortgages, repossession of home	If you are a low earner, there are no repayments to make; if there are repayments, they are deducted via payroll for employed individuals, so affordability is unlikely to be an issue
How long must you keep making repayments?	Until the debt is cleared in full	Until the debt is cleared in full, or until 40 years from the April following graduation – anything still owed after 40 years is forgiven
What if interest rates go up?	Monthly repayments will increase, unless your interest rate is fixed	Nothing changes, since the debt grows with inflation rather than interest rates

To labour the point: student loan repayments are only required if you earn enough, just like all taxes on earnings; if you stop earning you stop paying, just like all taxes on earnings; repayments are calculated as a % of earnings over a certain threshold, just like all taxes on earnings; after 40 years you'll stop repaying, a bit like how you stop paying National Insurance at State Pension Age. The similarities to tax are, in my view, greater than the similarities to a loan. The fact there is a balance owed which grows with RPI will be irrelevant for many graduates, since they'll never earn enough to clear it before it is wiped anyway.

The Answer

Perhaps I have successfully convinced you to reframe these loans as taxes, perhaps I haven't. Either way, I have yet to give you anything actionable in this article, so I shall try and do this now. If you're fortunate enough to be wondering if you should help your child with the costs or do something else with your money, in my view, the answer is below:

Take the loan.

Why? The terms of the loan are so generous that any other use of that capital for your child's financial future is likely to prove more beneficial for them than avoiding the loan.

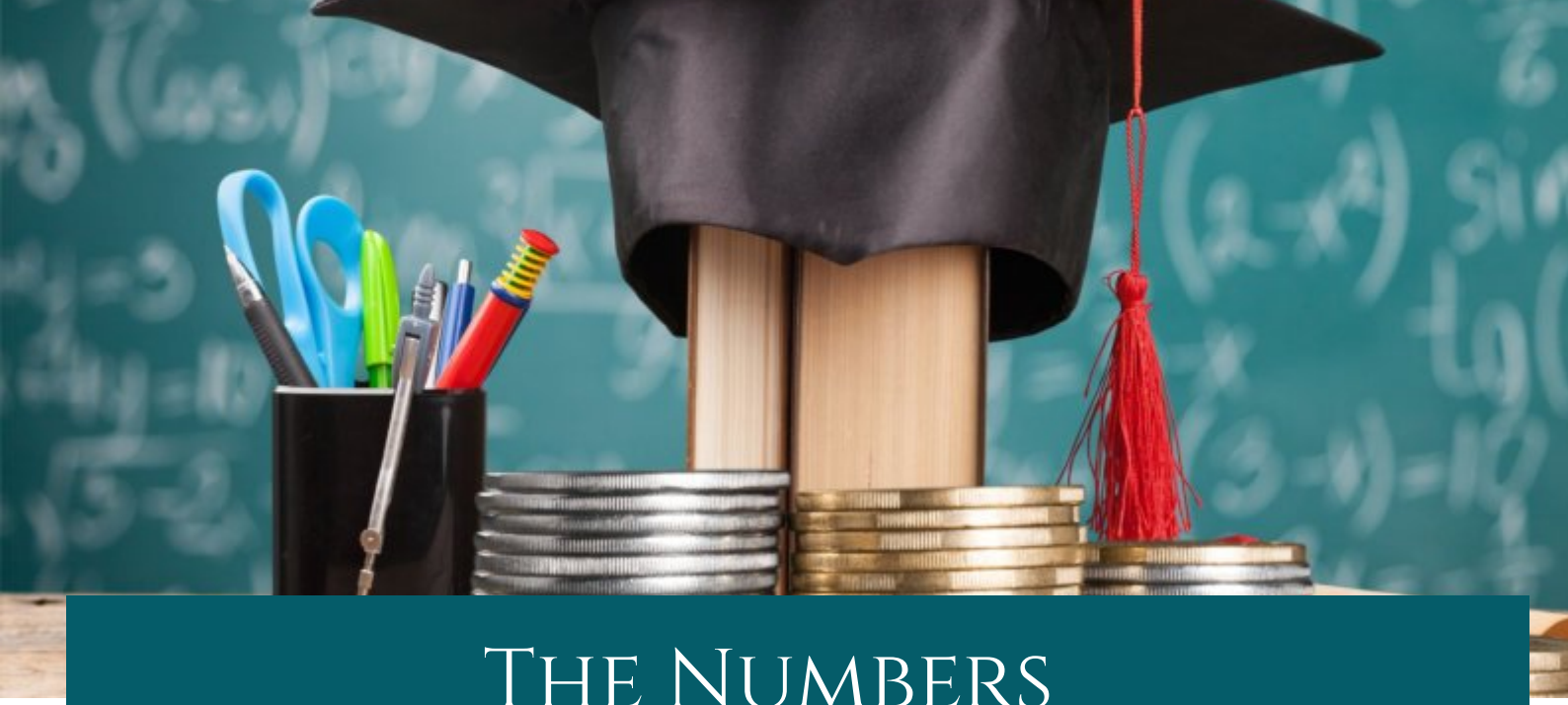
In economics, there is the concept of 'opportunity cost' which considers all the things you miss out on when you commit your resources to something – in other words, if your options are a or b and you choose b, the opportunity cost is a. In my view, the opportunity cost of clearing someone's student loan is almost always going to exceed the benefit.

Paying university fees might mean less capacity to help towards the deposit for a first home, meaning a bigger mortgage on terms far less favourable than a student loan, and possibly more time living at home with you or in rented accommodation whilst trying to save for a deposit.

Another opportunity cost might be a new car when your child starts work, meaning they opt for a finance deal also on terms far less favourable than the student loan; a more topical (although, admittedly, less prevalent) opportunity cost might be helping fund childcare for any grandchildren – averaging over £1,000 per month per child, this eye-watering expense is likely to dwarf almost anyone's monthly student loan repayment.

Even if you are wealthy enough to pay for university, and the house, and the car, and the grandchildren, you still have the opportunity cost of investing the money instead – given a long enough time frame, an investment in a globally diversified portfolio of equities will grow far more than a debt linked to RPI.

Another option to consider: if you would prefer your child did not incur the debt because you are concerned about the repayments, perhaps just cover your child's monthly repayments when they begin. If you invest the cost of the education at outset, there's even a good chance the investments could sustainably fund the repayments for you.



The Numbers

Here are some numbers to qualify the points made in the previous section.

A Typical Graduate

If we consider a fairly typical graduate with a starting salary of **£23,000** today and annual pay rises of **RPI + 1%,** they pay nothing towards their student debt for the first 3 years after graduation.

After 4 years, annual repayments begin at just **£78** (less than £7 per month). It would take around **36 years** to clear the debt, and the annual repayments peak (in the final year) at **£1,972** (c.£164 per month) in today's terms.

The total repayments are c.**£85,350** in nominal terms but remember, this has only grown by inflation so in today's money it is still worth only what was borrowed; by contrast, you'd need to keep the cost of that education invested for just 14 years after graduation for the value of the investments to exceed the total cost of the student loan.

This, by the way, is on the assumption you only borrow to cover tuition fees – many will also take maintenance loans (on the same terms) to cover sustenance but remember, anything still owed 40 years from graduation is forgiven, making the argument for taking the loan even more compelling.

It goes without saying we all hope our children will do well but, by definition, a significant proportion of graduates will do worse than average – probably more than half, if we assume the average is skewed upward by a small number of very high earners. We must also remember any career breaks, be they for a gap year, parental leave or providing other familial care, will play in favour of taking the loan.

If you invested the money instead the value would exceed the total repayments 14 years after graduation.

A Graduate on a higher starting salary

But let's also look at the scenario if your child does especially well – let's say they start on **£40,000**, instead of **£23,000**: repayments begin at **£1,235pa** (£103pm), they peak at **£2,637pa** (£220pm) in today's terms, and the debt is cleared **17 years** after graduating (again, I am assuming no maintenance loans for simplicity).

The total repayments are **£48,674** (as the debt was repaid sooner).

If you invested the money instead the value would exceed the total repayments just 7 years after graduation.

My Suggestion

For the vast majority of people, the best approach will be to take the loan and use the money you would have spent on university fees to benefit your child some other way.

The monthly repayments on a student loan are likely to be too small to even notice for most of their 20s, and a pot of cash (or better still, a portfolio of investments) will help them far more in getting on the housing ladder, starting a family and just generally building their financial security, than taking home slightly more money each month because they didn't have a student loan.

You don't have to know exactly how you'll use the money right now, but if it's likely to be 5+ years away then invest it. That's enough time to give the investments a good chance of growing faster than inflation, and inflation is a big threat to anyone planning to hold excess cash for the long term. In most cases, it will always be 5+ years before the money is needed as the standard degree is 3 years, and most graduates are still too busy finding their feet in a career 2 years after graduation to be considering life's biggest financial commitments.

If you've found this article useful and you'd like to speak to Lexington Wealth about your own finances (university funding or otherwise), please get in touch and we'll be glad to arrange an initial call to see how we could help.

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