THIRD WAY

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Privatizing Student Loans Isn’t a Silver Bullet

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In Washington, calling for increased efficiency is in vogue. In that vein, some recent higher education proposals have called for pulling the federal government out of student lending. [1] Although moving student loans to the private market may sound like the magic solution for student loan reform, privatization would present its own problems for students, families, and taxpayers. Meanwhile, the challenges it purports to address could be more efficiently achieved through greater accountability for programs within the existing lending infrastructure, and what Americans really want to see is reform, not abandonment, of the federal loan program. This memo unpacks common claims about student loan privatization and its potential impacts.

Claim: The Private Market Would Better Serve Students

Moving the student loan program to the private market would reduce access to higher education because the steeper barriers associated with borrowing would make college more—not less—expensive. Today's average student lacks the cash to pay for a college education outright. This is where the federal government steps in to support college access: after filling out the Free Application for Federal Student Aid (FAFSA), eligible students may be offered a Pell Grant, a student loan, or a combination of the two. Taken together, federal grants and loans are the primary way most of today's students pay for college. Unlike in the private market, federal loans do not require borrowers to provide collateral to back their loans, making federal borrowing for college widely accessible. Needing to put up collateral to qualify for a private loan would box many students out or would limit them to obtaining an unsecured loan—one where the lender considers the borrower's credit history, among other factors, to determine eligibility. For students with a limited credit history, no co-signer, and limited access to financial capital, reliance on the private market would jeopardize their higher education goals.

The cost of a private loan alone is a barrier for would-be students. The loan origination fees are higher, and students without a credit history would likely be charged a higher interest rate than a federally funded student loan. Today, private lenders charge interest rates ranging from 3% to 17.99%, compared to 6.53%, 8.08%, and 9.08% for federal Direct Subsidized and Unsubsidized Loans for undergraduates, Direct Unsubsidized Loans for graduate students, and Direct Graduate PLUS loans, respectively. [2] Even if a student can access a private loan based on their credit history, most unsecured loans require a co-signer. Under the best of circumstances, co-signing a loan carries significant financial consequences for the co-signer, including risks to their credit score, inability to access additional loans for their personal needs, the co-signed loan showing up on their credit report, and being required to pay the loan balance in the event of a student's default. [3] For many friends and family members of would-be students, co-signing the loan is a risk that they can't—and won't—be able to take on, to no fault of the student. Absent a lending program through the federal government, higher education would become nearly off-limits to students from low- to moderate-income backgrounds.

Government-held student loans also protect students against bad actors and offer legal recourse if they are defrauded or misled by their college or university. On the other hand, private loans contain limited student protections, rarely offer affordable repayment plans, and have almost no pathway out of default. [4] While state and federal agency enforcement actions in student lending have helped safeguard borrowers from some predatory lending practices, a full move to the private market would require much stronger oversight so lenders don't take advantage of students—a well-documented concern in the private student loan market. [5] Predatory private lenders have been known to target low-income students and withhold key information about the loan terms, fees, or risks for the student before signing the loan., They even establish preferred lending agreements that steer students to loan products with harsher terms or higher interest rates, removing their ability to shop around for the best rate or loan for their unique circumstances. [6] While the private market may seem better equipped to manage the student loan program, the reality is the opposite—and would leave students high and dry with higher costs.

Claim: Private Lenders Would Have Stronger Incentives to Promote Quality Programs

Since the passage of the *Higher Education Act of 1965*, federal student loans have played an essential part in expanding college access—a goal of both red and blue states alike, given higher education's impact on the workforce, state economies, and social mobility. [7] Despite the connection between federal lending and college access, privatization advocates argue that the current system supports too many bad loans that aren't worth taxpayer investment. They claim that shifting lending to the private market would lead colleges to price their offerings more competitively and focus on offering only programs with a high ROI, since private lenders are loath to make a malinvestment. However, increased reliance on private lenders would also position them squarely in the business of making judgments about the quality of the educational programs in which a student may want to enroll. This could give private lenders less incentive to loan tuition dollars to students interested in pursuing public service or professions of social good, like teaching or law enforcement, where earnings premiums are lower.

Taking the federal government out of the equation doesn't address the root cause of these issues. Low-ROI programs can access federal dollars right now because there aren't sufficient guardrails around student loans to hold colleges and universities in the loan program accountable for how well they serve students. Policy changes that strengthen upfront guardrails in the federal financial aid program and promote return on investment for students and taxpayers can tackle these problems head-on—without risking college access and affordability for millions by having the private market determine which borrowers to invest in, the differential terms for investing in borrowers, and which educational programs have value. With the decreased access that would inevitably follow a movement to the private market, there are plenty of red flags indicating that private lenders shouldn't be the primary source of a student's higher education funding, particularly at the undergraduate level.

Claim: Private Lending Would Be More Efficient

If you are thinking that privatizing student loans sounds familiar, you would be correct. From the passage of the *Higher Education Act of 1965* through 2010, the Family Federal Education Loan (FFEL) program provided student loans through a public-private partnership. Private lenders used their capital to fund student loans. In return, they received a federal subsidy to keep interest rates at congressionally-mandated levels to preserve higher education access and perform duties related to collections and default. [8] President Obama ended the FFEL program in 2010, citing that these subsidies paid to private lenders were a waste of taxpayer money and could be better used to support college access by increasing Pell Grant funding—savings to the tune of $68.7 billion over 10 years. [9] Ironically, President Obama noted the *exact* same reasons for a movement to direct federal lending that supporters of privatization use to bolster their argument, saying in 2009: "[U]nder the FFEL program, taxpayers are paying banks a premium to act as middlemen—a premium that costs the American people billions of dollars each year. Well, that's a premium we cannot afford—not when we could be reinvesting that same money in our students, in our economy, and in our country." [10]

Some would argue that the FFEL program wasn't true privatization, but that doesn't mean another attempt to privatize the loan system is the appropriate fix. If the goal is cost-savings and increased efficiency, moving the primary way most students access higher education to the private market would be remarkably *in*efficient and costly for taxpayers. There are, however, fruitful conversations to be had about whether some types of loans are better suited for privatization than others. While the student loan narrative often highlights the challenges facing undergraduate students, the most significant investment is in the graduate student loan program, which comprises over half of outstanding federal student loan debt. [11] Privatization could play a role in helping curb graduate student loan debt. Still, it isn't the only solution—and must be taken in tandem with other policy levers like instituting reasonable caps on Grad PLUS lending. [12] While some high-ROI graduate loans may be good candidates for the private market, the challenges for access and cost at the undergraduate level make the risk of privatization far greater than the reward.

Claim: Americans Want the Federal Government Out of Student Lending

Third Way polling has found that 68% of American voters—including 64% of Republicans and 72% of Democrats—feel that the higher education system's problems can be addressed with reforms that fix what's broken while leaving what works in place. [13] That ethos matches what Republican voters want to see from the student loan program. A recent Third Way survey of Republican voters found that only 54% support fully privatizing the student loan program—making it among the higher education policies with the least Republican support, in 11th place of the 12 policy options we tested and almost 30 percentage points lower than the top-supported policy. [14]

Voters are most interested in seeing action on student loans that helps control costs and promote value. Sixty-six percent of voters believe that the federal government should regulate *all* colleges and universities to ensure they provide a good ROI for students, and a majority of voters support additional guardrails and metrics to hold institutions accountable to students and taxpayers. These fixes would curtail the loan program's cost by ensuring that all programs receiving Title IV federal financial aid deliver positive returns. The key takeaway for policymakers is clear: voters recognize issues with higher education, but they want those fixed without undercutting the access made possible through federal lending.

Conclusion

"Efficiency" and "productivity" are big buzzwords these days, but when it comes to the federal student loan program, being efficient and productive means working on reforms that promote increased accountability for institutions participating in the student loan program. Beyond being cumbersome and disruptive to students, a wholesale movement to the private market without pursuing pathways that fix the flaws in the current system—like holding colleges and universities to a higher standard for postgraduate outcomes and earnings rates to access federal loans—is a missed opportunity to deliver on reforms that would better serve students and save taxpayer dollars.

ENDNOTES

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