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A QUICK LOOK INTO IMPORTANT ISSUES OF THE DAY

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Refinancing Student Loans

BY DUSTIN WEEDEN

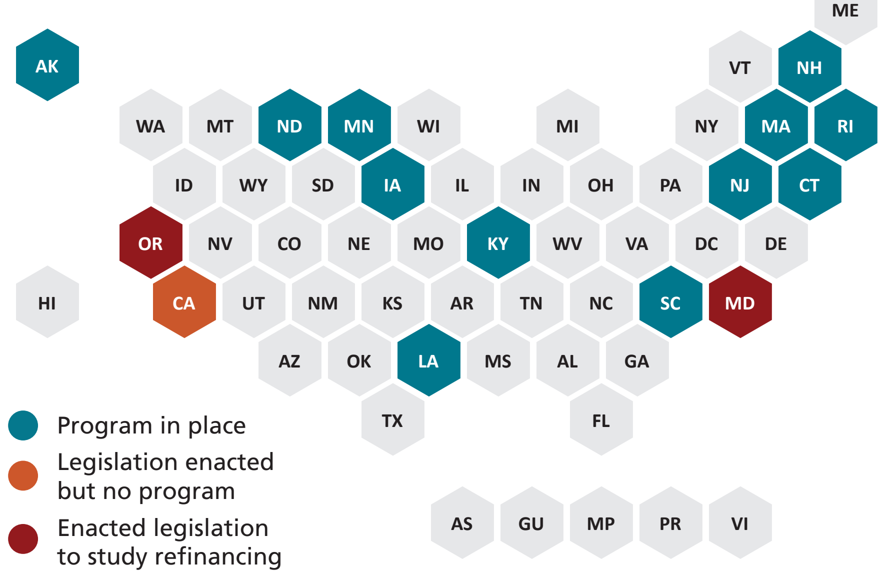
The number of students borrowing for higher education expenses increased 89 percent between 2004 and 2014. During that time, average debt per student increased 77 percent, and over 5 million borrowers defaulted on their loan obligations. These trends have led to greater concern among policymakers about the amount students are borrowing, their ability to repay, and the broader economic effects of student borrowing.

States have considered several policies in recent years to reduce the debt burden on students. Refinancing existing student loans at lower interest rates is one solution that has received attention not only in state and federal government, but also in the private market.

Because student loan interest rates change with economic conditions and policy changes, students borrowing in different years can end up paying significantly different rates. A student taking out a federal loan to pay for college-related expenses for the spring semester in 2007 would have had to repay the loan with a fixed interest rate of 6.8 percent. A student taking out a similar loan for the spring semester in 2017 will have to repay the loan with a fixed interest rate of 3.76 percent. While borrowing costs vary from year to year for all forms of credit, options to refinance student loans with higher interest rates—available for other lines of credit—were not widespread or even available at all for student borrowers until recently.

A fairly robust private refinancing market has developed in the current era of low interest rates. These private financial companies, including banks and credit unions, tend to require high credit scores and cosigners, and even target graduates of certain institutions. Private refinancing operators have been accused of "cream skimming," or refinancing loans of those with great credit and high-paying jobs. Consequently, state-based, non-profit programs with broader eligibility requirements have thrived alongside the private providers.

State Student Loan Refinancing Programs



Source: NCSL, 2017

State Action

Twelve states currently operate a student loan refinancing program (see map). Three states created programs through legislation—Connecticut, Minnesota and North Dakota—while the other nine states started refinance programs without legislative approval.

Refinancing is often done by state loan authorities. As the student loan industry developed in the 1970s and 1980s, many states created such authorities to issue supplemental loans—loans for which students are eligible after taking out the maximum federal loan amount—and act as guaranty agencies for federal loans. Other than North Dakota—where the state bank is the refinancing entity—state refinancing programs are run through these quasi-public loan authorities.

There are two primary reasons for using state loan authorities to refinance existing loans. First, these authorities originate new loans and have the experience and capacity to service refinanced

Did You Know?

Total outstanding student loan debt is $1.4 trillion.

North Dakota residents can refinance student loans for a variable interest rate as low as 2.35 percent.

Federal student loan interest rates adjust annually based on the yield of the 10-Year Treasury Note.

loans. Second, because the state loan authorities issue tax-exempt revenue bonds to finance their operations, they essentially are self-sustaining and receive very little, if any, revenue directly from the state. Because the authorities rely on tax-exempt bonds, states were slow to create refinancing programs until the IRS provided guidance that revenue from tax-exempt bonds could be used to refinance student loans not originally issued by the state loan authority. As a result, the number of states offering programs more than doubled in 2016.

Only states with pre-existing student loan authorities have created refinancing programs. States without these entities have explored different options to refinance student loans. Maryland and Oregon passed legislation in 2016 to study creating a state refinancing program with a loan authority or other means. California passed legislation to create a student loan refinancing program in 2014. In contrast to other states that allow federal and private loans to be refinanced, the California legislation allows only private loans to be refinanced. However, the structure of California's program requires an additional appropriation from the state that has yet to be allocated.

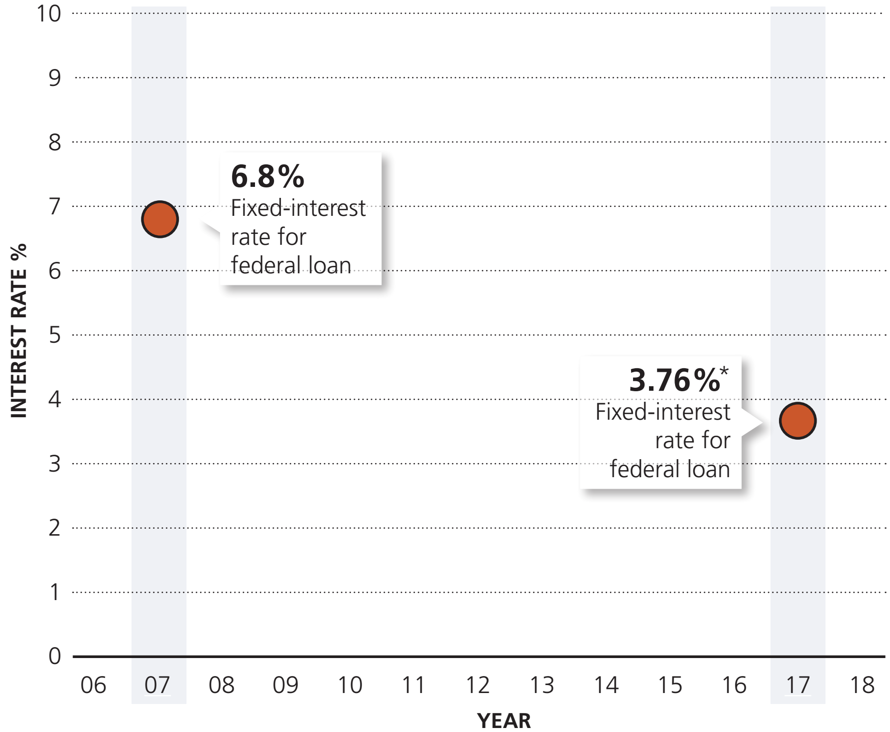
Other states—including Montana, Nevada and New York—have considered legislation in recent years to create a refinancing authority, but so far more substantial bills like these have not been enacted. Rather than creating a new authority to refinance loans, Wisconsin has made sure private refinancing options, through credit unions and other financial companies, are available to all state residents.

Federal Action

While private loan interest rates are set by the loan provider and vary by characteristics of the borrower, federal student loan interest rates are established by Congress and are fixed for all borrowers. Current federal law sets student loan interest rates a few percentage points above the 10-Year Treasury Note. Specifically, rates for undergraduate loans are 2.05 percent, graduate student rates are 3.6 percent, and parent loans and certain graduate student loans are 4.6 percent above the Treasury Note. This policy ensures that student loan rates move in concert with broader changes in interest rates rather than being arbitrarily set by Congress. Because parents and graduate students must repay loans at higher interest rates than undergraduate students, these borrowers have been the primary beneficiaries of state and private refinancing programs.

Legislation introduced in the House and Senate to establish a federal student loan refinancing program did not move forward in the 114th Congress. A federal refinancing program would allow borrowers to retain certain protections—including income-driven repayment, deferment and forbearance—that they lose when they refinance federal loans with state and private providers.

The Difference a Decade Makes: Fluctuating Student Loan Rates



*Note: Congress establishes federal student loan interest rates, and current law sets the rate 2.05 percent above the Treasury Note's 10-year yield of 1.71 percent.

Source: U.S. Dept. of Education

Additional Resources

NCSL Student Loan Debt webpage

Education Finance Council

NCSL Contact

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