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How student loan forgiveness will ripple across financial services

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WASHINGTON — President Biden's announcement Wednesday that the Department of Education would forgive up to $20,000 in student debt for eligible borrowers could have major implications across the financial system.
The plan would forgive up to $10,000 in federal student debt for borrowers earning under $125,000 per year, and up to $20,000 in student loans taken out by lower-income Pell Grant recipients. Biden also announced that the moratorium on all student loan repayment that has been in effect since 2020 would cease at the end of the year and provided new rules governing student loan repayment and public service debt forgiveness going forward.

Biden said the purpose of the plan was to reduce the burden of student loans for those struggling to build financial security, freeing up income to spend and invest in a stronger economy.

"All of this means people can start finally to climb out from under that mountain of debt," Biden said Wednesday. "To finally think about buying a home or starting a family or starting a business. And by the way, when this happens, the whole economy is better off."

Many Democrats have been calling on the president to cancelsomeportion of federally held student debt since he took office. He already announced billions in loan forgiveness for certain borrowers who attended for-profit institutions and those who have pursued public service jobs. Yet much of that careful thinking around Wednesday's announcement relates to the precarious economic context in which the announcement was made; the Federal Reserve has been aggressively hiking interest rates to tame runaway inflation, leading to growing fears that the economy could be heading into a recession.

Banks as a general matter do not hold a great deal of student debt — private student debt accounts for a little under 8% of the total $1.75 trillion student debt market, the vast majority of which is held by the Department of Education, Sallie Mae and other quasi-governmental organizations. But the announcement likely will affect consumer credit, inflation and the broader economy.

Here are some of the main ways Biden's student loan announcement could change the political, economic and lending landscapes in the years to come.

'Clear positive' for consumer credit
The announcement is a "clear positive" for all consumer lenders, whose customers will be better able to manage payments on other loans, according to Piper Sandler analyst Kevin Barker.

In addition to forgiveness, the administration is also capping some borrowers' repayments at 5%

of their monthly discretionary income.

"Consumers will have more flexibility to pay down credit card, auto and personal loan debt without having the burden of student debt payments," Barker wrote in a note to clients.

That should help credit card companies such as Capital One Financial, Synchrony Financial, Discover Financial, the installment lender One Main Financial, and the buy now/pay later lender Affirm, Barker wrote.

Other beneficiaries include Ally Financial, whose biggest business is auto lending, and Citizens Financial Group, which has a heavy presence in the consumer finance space and also offers private student loans.

The announcement comes as worries start to grow about consumers' health, with late payments rising significantly **among nonbank subprime lenders** and more modestly at banks.

A sudden restart of loan payments "would have further inflamed the increasing default rates we are currently seeing" in many types of consumer credit, Barker wrote.

But Morgan Stanley analyst Jeffrey Adelson had a more pessimistic outlook, saying in a client note that the potential resumption of student loan payments in 2023 if the moratorium isn't extended again "adds another risk to consumer credit quality."

"Lower credit score consumers holding a larger share of student loan debt means they receive a relatively large percentage of the benefits from forgiveness," Adelson wrote. "However, it also means that these consumers will be more affected when payments turn back on." — *Polo Rocha*

Spillover benefit for private lenders

One major beneficiary is the online lender SoFi Technologies, whose student loan refinancing business has been lagging as potential customers waited for an announcement from Biden before making any decisions.

"This announcement is an important step towards removing a key overhang for SoFi, as an end to the moratorium should drive a surge in private student loan refi volumes in 2023," Adelson at Morgan Stanley wrote.

That is because SoFi focuses on higher-income borrowers — with a weighted average income of $170,000 — whose loans are unlikely to qualify for forgiveness and may look to refinance when repayments begin.

In April, CEO Anthony Noto told analysts that forgiveness of $10,000 "would be great for our business."

"There's a cohort of people that have been waiting and waiting and waiting for student loan forgiveness and they have not refinanced," Noto said, adding that "once there actually is forgiveness, there's nothing to wait for anymore."

Other private student lenders may also benefit slightly because borrowers whose loans were forgiven will have more money available to pay back private loans, analysts say.

The credit quality boost will be particularly notable at Sallie Mae, which specifically focuses on students, according to RBC Capital Markets analyst Jon Arfstrom. Other lenders with a smaller concentration of private student loans would see a similar boost, including Discover Financial, where private student loans make up more than 10% of its loan book.

But the announcement is likely to have a negative impact on Navient and Nelnet, according to Giuliano Bologna, an analyst at Compass Point. The two companies have contracts with the federal government to administer federal student loan borrowers' repayments, and forgiveness would decrease the revenues they get since they will service fewer borrowers.

Nelnet disclosed the potential impacts in a quarterly filing to investors, saying that a broad forgiveness program of $10,000 could decrease the borrowers it works with to 11.1 million, down from 15.4 million at the end of June. — *Polo Rocha*

Booster shot for deposits

Student loan forgiveness is, in effect, a large stimulus package. That's likely to, in turn, bolster banks' liquidity like other waves of relief to consumers did throughout the pandemic.

In the last few years, pandemic-era stimulus checks helped fuel a rise in deposits at banks. With student loan forgiveness targeting earners up to $125,000 annually, it stands to reason that banks will see a similar trend: With government stimulus, lower and middle-class earners could have more money to spend and save, buoying deposits.

The glut of deposits has been thrown into the forefront of discussion among bank regulators in recent months. The Federal Deposit Insurance Corp. has **said it will raise assessment fees by 2 basis points for all insured depository institutions**. The change is part of a plan to get the Deposit Insurance Fund's reserve ratio to the 1.35% statutory minimum by 2028, and raising rates now could prevent a steeper increase closer to that date.

That would likely raise costs for banks, although FDIC acting Chairman Martin Gruenberg has said it will have only a "modest" impact. Predictably, **banks have pushed back against that plan**, arguing that, since government stimulus has largely ended and the Federal Reserve looks to raise interest rates and otherwise tighten policy.

Banking groups, in comment letters to the FDIC in response to the agency's plan to raise assessment rates, said that they expect deposit growth to slow, making the fee increase unnecessary. However, student loan forgiveness could ease some of the economic pressure that would otherwise slow deposit growth. With student loan borrowers potentially able to save more, deposits could continue going up.

Yet other factors are at work. It remains unclear if tightening policy from the Fed — which could trigger a recession — will offset the economic bounce from student loan forgiveness. — *Claire Williams*

Possible inflation fuel

One of the most debated aspects of the Biden administration's plan to forgive roughly $400 billion of student loan debt is how it will affect inflation.

Opinions on the matter vary widely. Jason Furman, chief economic advisor for then-President Barack Obama, **tweeted** that the move is the equivalent of "[p]ouring roughly half trillion dollars of gasoline on the inflationary fire that is already burning is reckless."

Goldman Sachs, on the other hand, expects the move to have a minimum economic impact. In a research paper distributed Thursday, the investment bank projected that the program would increase gross domestic product by 0.1% next year and by less in the years ahead, with the inflationary impact charting a similar path.

Some officials and commentators have even suggested that the White House's plan could be deflationary as it calls for an end to the federal student loan repayment moratorium implemented at the beginning of the pandemic. Borrowers will have to resume making monthly payments starting in January.

Unlike stimulus payments or even tax credits, there is no transfer of money to borrowers, only a reduction of debt on their personal balance sheets. This raises the question of whether these individuals feel wealthier and, if so, whether that induces more of the demand that the Federal Reserve is **attempting to quash through higher interest rates**.

Derek Tang, co-founder of the Washington-based research firm Monetary Policy Analytics, expects demand to be little changed as a result of the debt cancellation. Not only have borrowers been able to forgo their loan payments during the moratorium, but many have long priced some degree of loan forgiveness into their personal budgets because Biden promised it on the campaign trail in 2020.

"There was already a lot of speculation that, at some point during the Biden presidency, these loans would be forgiven," Tang said. "A lot of people might have been counting on it halfway already, so the resulting impact on their spending patterns might not be as big as if this was like a complete surprise."

Still, Tang said, even a modest increase in demand could warrant additional action by policymakers in Washington, especially since **recent rate increases by the Fed** have done little to cool off a red-hot labor market.

"If it does end up being a little bit more inflationary than we expect, especially next year, it might have an impact on what the Fed does, because the Fed is trying to bring inflation down to 2% and every 10th of a percent counts," he said. "Even if this is going to generate a 10th more inflation, that's going to make the Fed's job a little bit more difficult. The Fed can only bring inflation down by reducing demand, and what that means is it's going to have to push the labor market down a little bit more to get what it wants."

If demand is to rise in the immediate aftermath of the debt cancellation, it is most likely to center on credit-intensive purchases, such as homes and automobiles, which have already seen significant price increases in recent years due to supply and demand imbalances. Yet even skeptics of the policy do not expect this to be a significant driver of overall inflation.

Neal McCluskey, director of the Center for Educational Freedom at the libertarian think tank

Cato Institute, said he expects a near-term inflation increase following the cancellation will be "real but small" and likely hard to isolate among the various other factors that have caused prices to rise this past year — including fiscal stimulus programs and supply chain bottlenecks.

In the long run, McCluskey said the ripple effects of the Biden administration's action on student debt will have a significant inflationary impact on the world of higher education. He expects future students will be more willing to take on debt under the expectation that it will be forgiven and universities, in turn, will increase their prices.

"Many people will look at student loans now and say, 'Well, why shouldn't I take out student loans and take out more?' Because once there's a precedent for cancellation they can say 'OK, why did you forgive them three years ago and not now?' " McCluskey said. "Colleges will see that and raise their prices, not just because they can, but because they have things they think would be valuable to do and they need money to do it. That's one way to get it." — *Kyle Campbell*

Paradigm shift for debt forgiveness

The White House's approach to student debt forgiveness is a far cry from some of the all-encompassing strategies pushed for by progressive advocates, whose plans had ranged from $50,000 in forgiveness to, **well, all of it.** But even on a relatively small scale, the Biden forgiveness framework represents a type of intervention that is quite unprecedented in the modern American economy — a modern, miniature debt *jubilee*.

Defined loosely as a broad, societywide declaration of debt forgiveness, jubilees have been strewn across world history and date **as far back as the ancient Sumerians**. But outside the painful strictures of bankruptcy court or limited programs for public employees, the broad public forgiveness of consumers' debt remained unheard of in the United States until Biden's announcement on Wednesday.

With the genie out of the proverbial bottle, there may be reason to believe this won't be the last time policymakers consider sweeping debt forgiveness in student lending and beyond. The underlying causes of the student debt bubble have not been addressed, meaning that in lieu of legislative educational reform, courtesy of Congress, the problem is likely to reemerge for future student borrowers.

The Biden administration's approach to debt forgiveness via the Department of Education may also be challenged in court in the coming weeks, forcing the administration to explore alternatives that affect the scope of how much debt is ultimately forgiven. "It is too early to gauge whether any legal challenge will prove successful, and there are viable questions regarding who has sufficient standing to bring an action," Isaac Boltansky, a director at BTIG, said in the analyst note, "but we believe there is a relatively high likelihood that we see a legal challenge to this policy."

But even if the debt forgiveness plan stands, activists and their allies in government have made clear they don't believe enough debt has been forgiven. Rep. Alma Adams, a North Carolina Democrat, said in a statement Wednesday that the White House plan "must be a first step, not the last step."

"As long as the debt is too damn high, we still have work to do in Congress," Adams said. — *Brendan Pedersen*