US Economics | North America

Student Loan Restart Will Reduce Buying Power

Student loan interest payments are expected to resume soon. We size up the impact to consumption and growth this year and which demographic groups will be most affected.

- The more than three year long moratorium on federal student loans will come to an end soon, with interest payments expected to resume October 1. This would impact the 26.6 million borrowers who have federal student loans in forbearance totalling $1.1tn or $41k/borrower. This assumes the Biden Administration does not leverage a grace period that could enable students to restart student loan payments 3-6 months after the moratorium expires.

- We estimate the hit to disposable income from the end of the student loan moratorium lowers real PCE this year by 8-12bp and real GDP by 6-9bp, a drag already built into our Mid-Year Outlook. The largest impact will occur in October, when spending level shift lower to incorporate higher debt service costs.

- In our Mid-Year Outlook, we outlined our expectation for consumers to pull back on overall discretionary spend as a weakening labor market, higher interest rates, and the end of the student loan moratorium reduce consumer buying power. We initially assumed an earlier resumption of student loan payments in 3Q23, but new information on a later expiration pushes out spending weakness into 4Q23.

- In 2019, the average interest payment made on student loans by adults who had to make payments (70% of borrowers) was between $200 and $300 each month. If all borrowers in forbearance were to restart interest payments of $200 to $300/month, this will total $5.3bn to $8bn in interest payments monthly, or $64-$96bn/annually - equivalent to 0.3%-0.5% of disposable income.

- Different demographic groups will be disproportionately affected. According to a Federal Reserve report, lower-middle income households, black and hispanic borrowers, and borrowers who did not finish college or have a technical degree are more likely to fall behind on student loan payments when they resume.

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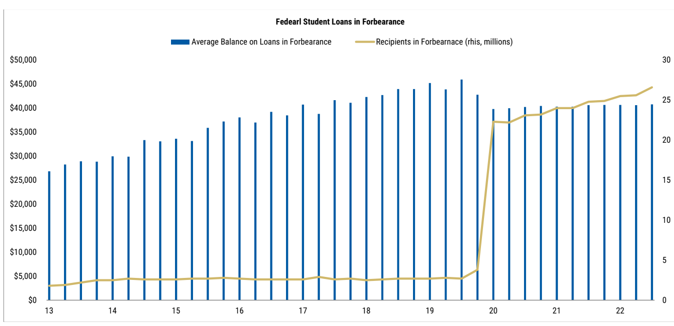
As part of the debt ceiling resolution reached in early June, it was agreed that the moratorium on student loan payments is coming to an end after over three years. The moratorium will end 60 days after June 30th, which means that after August 29th, interest on student loans is expected to start accruing again with payments beginning October 1. This would impact the 26.6 million borrowers who have federal student loans in forbearance totalling $1.1tn or $41k/borrower. Our analysis assumes the Biden Administration does not leverage a grace period that could enable students to restart student loan payments 3-6 months after the moratorium expires. We expect to see a hit to disposable income and a moderate pullback in discretionary spending in 4Q23. We estimate the student loan moratorium expiration shaves ~10bp off real PCE growth this year and ~7bp off real GDP growth.

Who Holds Federal Student Debt

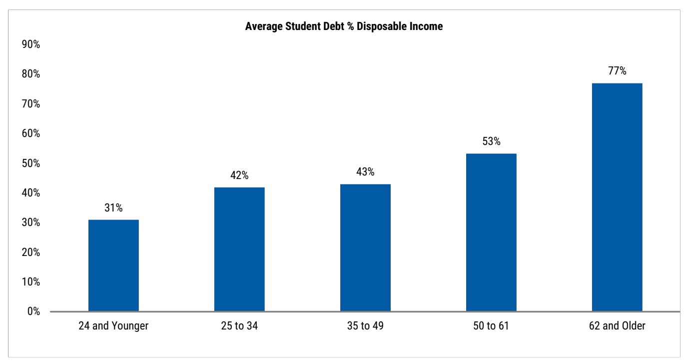
As of 1Q23, there were 43.8 million federal student loan borrowers, averaging $37,338 in outstanding principal and interest payments per borrower ($1.5tn in total student debt). Within that, **26.6 million borrowers are currently in forbearance, with each borrower in forbearance holding on average $41k in outstanding principal and interes**t ($1.1tn in forbearance, Exhibit 1).

Exhibit 1: Nearly 27 million adults have federal student loans in forbearance



Source: Department of Education, Morgan Stanley Research

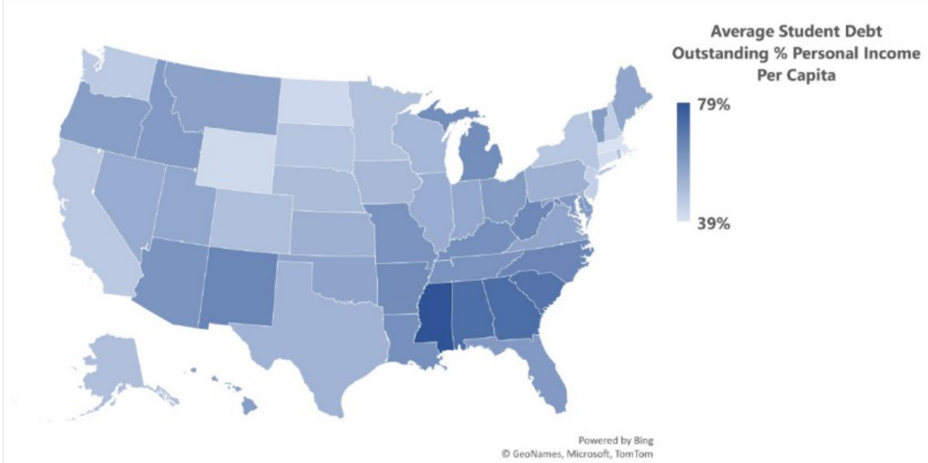
Exhibit 2: Debt balances are largest for adults 35+



Source: Department of Education, Morgan Stanley Research

There are significant demographic differences in who holds federal student debt and which groups are more likely to be behind on payments. Those aged 25 to 34 are the most likely to hold student loan debt, but borrowers aged 35 and older hold the largest debt balance in dollar terms and as a share of disposable income, while head of households aged under 24 have the smallest debt balance (Exhibit 3). Southern states, including Mississippi, Alabama, Georgia, and South Carolina have the highest average student loan balance as a share of per capita disposable income, while states in the Northeast, like Massachusetts, Connecticut, New Jersey, and New Hampshire have the lowest (Exhibit 3). This is more a product of lower disposable income than higher student loan balances.

Exhibit 3: States with lower income per capita have higher student debt burden



Source: Department of Education, Morgan Stanley Research

Our own AlphaWise Consumer Pulse survey provides further details on the demographics of student loan borrowers. We find that student debt holders are more likely to be women, under the age of 35, from the South Atlantic/Northeast/Midatlantic, have an annual income between $25k-$100k, and have a full-time job (see Appendix - Demographic Characteristics of Student Loan Borrowers from our AlphaWise Consumer Pulse Survey for charts).

According to the Federal Reserve's 2022 Report on the Economic Well-Being of U.S. Households (released May 2023), adults who make under $25k/year are 5x more likely to be behind on student loan payments than those who make $100k+. Similarly, adults with only some college education or a technical degree are nearly 5x more likely to be behind on payments that those with a graduate degree (Exhibit 4). The report from 2019 finds that Black and Hispanic borrowers are 3-4x more likely to be behind on payments than white borrowers (Exhibit 5).

Exhibit 4: Lower income and less educated borrowers more likely to be behind on student loan payments

Behind on student loan payments (by family income and education)

Characteristic	Percent
Family income	
Less than $25,000	25
$25,000–$49,999	21
$50,000–$99,999	12
$100,000 or more	5
Education	
Some college or technical degree	28
Associate degree	19
Bachelor's degree	7
Graduate degree	6

Source: Federal Reserve, Morgan Stanley Research

Exhibit 5: Black and Hispanic borrowers more likely to be behind on payments

Payment status of loans for own education among borrowers under age 40 (by race/ethnicity), 2019

	Percent		
Race/ethnicity	Behind	Current	Paid off
White	7	64	29
Black	26	63	11
Hispanic	19	60	21

Source: Federal Reserve, Morgan Stanley Research

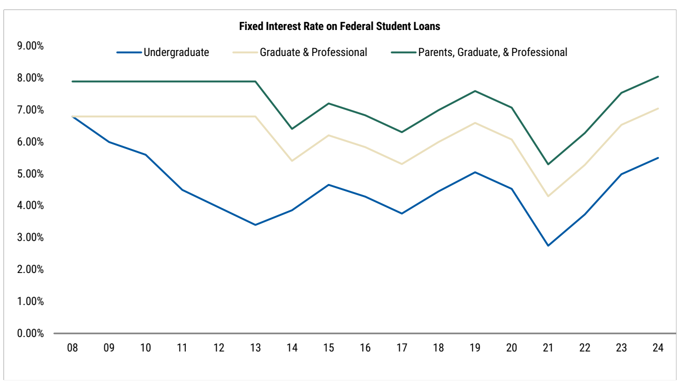
Cost of Servicing Debt

If the student loan moratorium expires at the end of August as expected, households will need to resume paying interest on their loans beginning October 1. The demographic groups outlined above are likely to be the most affected by the resumption of interest payments. Interest on new student loans has risen over the past year, but has been balanced by lower rates in the two years prior.

According to the Department of Education, **the fixed rate on newly originated federal student loans for 2H23-1H24 is 100bp higher than it was prior to the moratorium starting**. For undergraduates, the fixed rate is set at 5.5% for this year vs. 4.5% in 2020, for graduates the fixed rate is set at 7.1% vs. 6.1% in 2020, and for parents/professionals it is set at 8.1% vs. 7.1% prior (Exhibit 6).

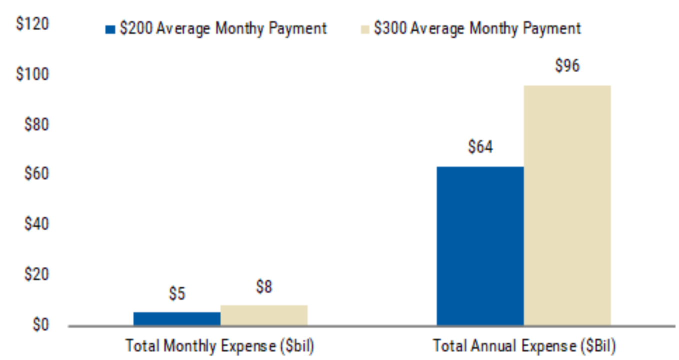
According to the Federal Reserve's Report on the Economic Well-Being of U.S. Households in 2019, the total monthly payment made on student loans by adults who had to make payments (70% of borrowers) was between $200 and $300 each month. Since the moratorium began, these interest payments fell to zero. **It is likely that with the resumption of interest payments, the average interest expense will be similar to 2019**. While the interest on new student loans for this year is 100bp higher than three years ago and the interest on loans last year are 50bp higher, the interest on student loans in 2020 and 2021 are significantly lower given that short-term interest rates were at the zero lower bound. Over this time frame, there is also the opportunity for student loan refinancing assuming the borrower meeting underwriter criteria.

Exhibit 6: Fixed interest rate on newly originated federal student loans rising



Source: Department of Education, Morgan Stanley Research

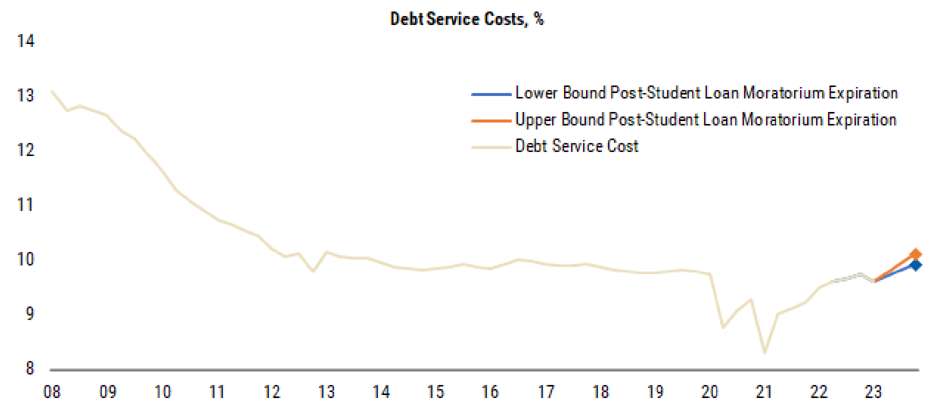
Exhibit 7: Estimated $5-8bn need for student payments monthly



Source: Federal Reserve, Department of Education, Bureau of Economic Analysis, Morgan Stanley Research

There are currently 26.6 million federal student loan borrowers in forbearance. **If all borrowers in forbearance restart monthly payments of $200 to $300/month, this will total $5.3bn to $8bn in payments monthly, or $64-$96bn/annually (Exhibit 7). If all of this were interest, it would lift household debt service costs by 30-50bp, from 9.6% as of 1Q23 to 9.9%-10.1% in 4Q23 when payments resume (Exhibit 8) and is equivalent to 0.3% to 0.5% of disposable income.**[1] *That said, only part of the repayment is interest, meaning that the debt service cost increase is lower. However, only 17% of the adult population has student loans, meaning that the debt service burden to the group with student loans is higher than the 30-50bp to the overall debtor population.*

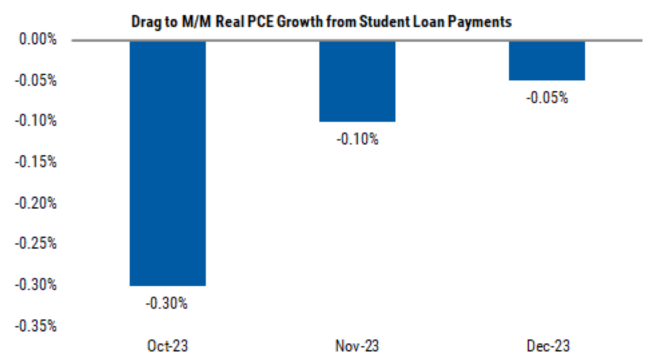
Exhibit 8: Debt service costs to bump up in 4Q23



Source: Federal Reserve, Morgan Stanley Research

The impact to consumption spending is expected to occur in 4Q23, shaving 8-12bp off real PCE growth this year and 6-9bp off real GDP growth. In our Mid-Year Outlook, we had assumed an earlier start day for student loan repayment in 3Q23, so the later start date in 4Q23 is expected to push out more weakness in consumption from 3Q into 4Q. The impact is spread across October-December, with the largest step down in consumption expected to occur in October 2023 (Exhibit 9), but the overall effect on consumption and GDP growth this year is unchanged from our outlook. If the grace period extends the repayment start date, this would continue to push out consumption weakness into 2024.

Exhibit 9: A pullback in consumption in 4Q23 when payments resume



Source: Bureau of Economic Analysis. Morgan Stanley Research

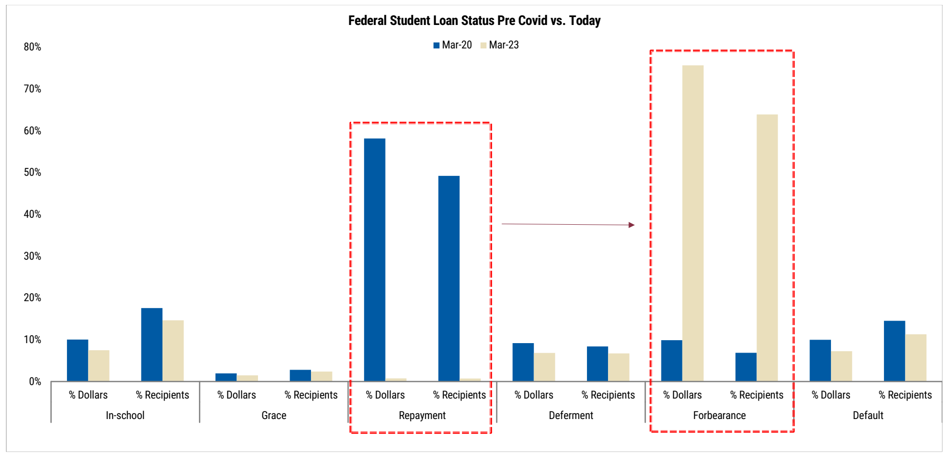
In our funding path, we assume 90% of the funding for student loan repayment comes from lower consumer spending and 10% comes from higher end consumers reducing savings. This reflects our view of the greatest risk to consumption estimates. There is the possibility that consumers chose to increase debt elsewhere to continue current consumption, I.e., shift a portion of credit card payments to student loan repayment , in order to maintain current spending levels. Either way, our Consumer Finance Equity Analysts expect that the restarting of student loan repayment will increase overall default and ncos over the next year as not every student loan borrower has an incremental $250 per month set aside to repay this debt. The expiration of the moratorium is another headwind to discretionary spending this year and next year as a softening labor market and dimmer economic outlook leads consumers to become more cautious shoppers.

Current Loan Status of Federal Student Aid Borrowers

There are several payment categories student loan borrowers can fall into: repayment, deferment, forbearance, and default. When a borrower cannot make a payment, the loan can be deferred or put in forbearance. According to NerdWallet, interest typically accrues during these periods, but borrowers with subsidized loans don't owe the interest that accrues during deferment.

At the onset of Covid, 50% of borrowers were in repayment, 7% in forbearance, and 15% in default. Once student loan forbearance began, repayment fell to 1% and forbearance jumped to 64%. **With nearly all borrowers in forbearance, there has been a tick down in defaults as well (Exhibit 10)**.

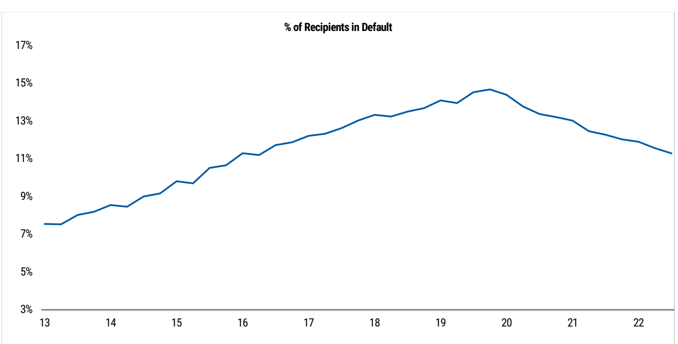
Exhibit 10: There has been a massive shift from repayment to forbearance due to the moratorium



Source: Department of Education, Morgan Stanley Research

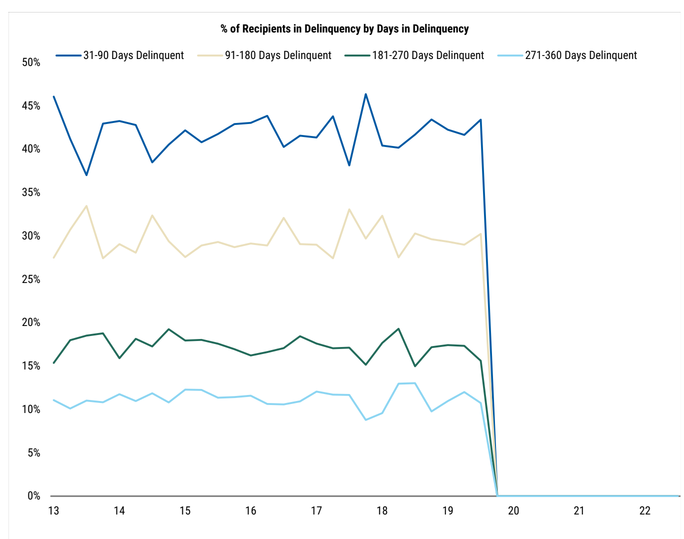
It is not clear how this chart will look in 4Q23 once we get the first data following the expiration of the moratorium. Prior to Covid, the share of recipients in default had been steadily rising for seven years despite a robust economy and strong labor market (Exhibit 11). However, the share of delinquent borrowers who were only 31-90 days delinquent was steadily the largest share (50%) over the past decade (Exhibit 12). **Today, consumers are more burdened by higher debt service costs and higher inflation, which will likely weigh on student loan performance following the end of the moratorium.**

Exhibit 11: Default rates were rising pre-Covid



Source: Department of Education, Morgan Stanley Research

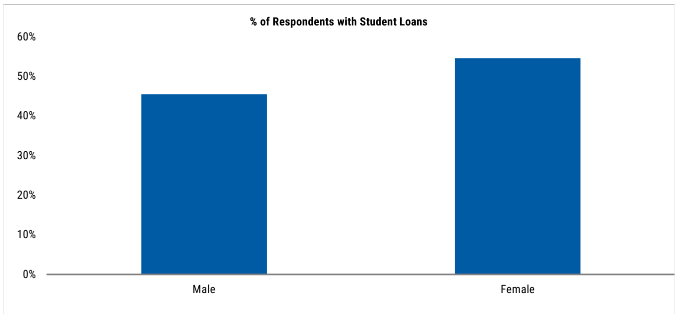
Exhibit 12: But most borrower remained in 31-90 days delinquent



Source: Department of Education, Morgan Stanley Research

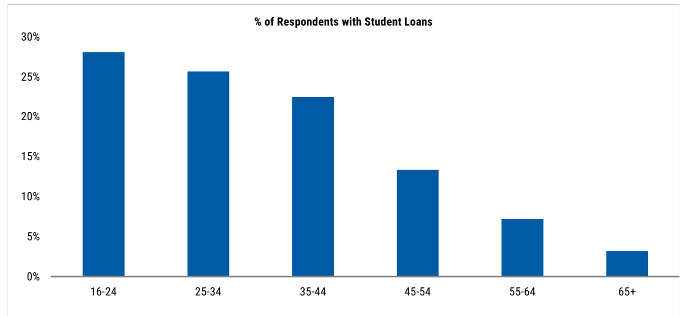
Appendix - Demographic Characteristics of Student Loan Borrowers from our AlphaWise Consumer Pulse Survey

Exhibit 13: Student loan by sex



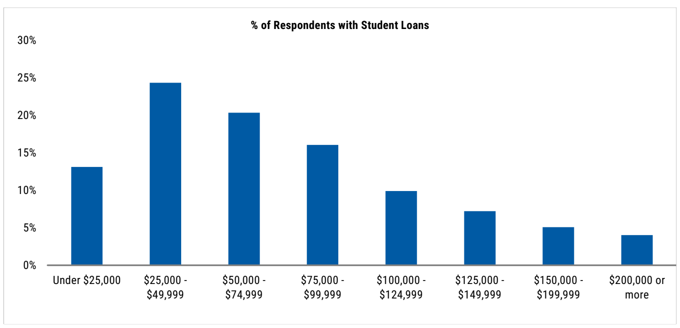
Source: AlphaWise, Morgan Stanley Research

Exhibit 14: Student loan by age



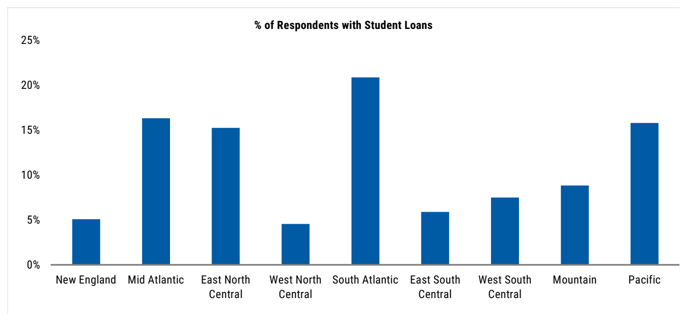
Source: AlphaWise, Morgan Stanley Research

Exhibit 15: Student loan by income



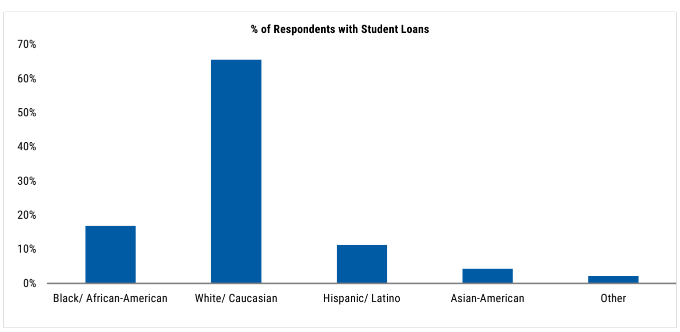
Source: AlphaWise, Morgan Stanley Research

Exhibit 16: Student loan by region



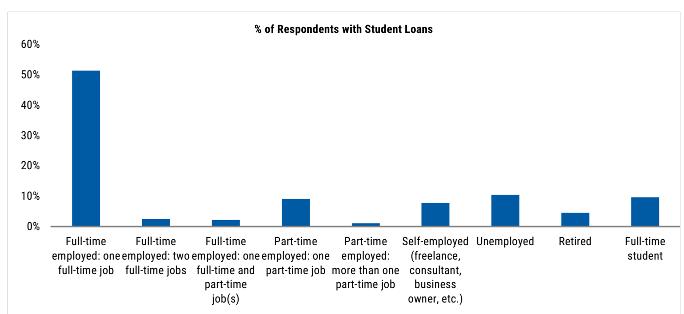
Source: AlphaWise, Morgan Stanley Research

Exhibit 17: Student loan by ethnicity



Source: AlphaWise, Morgan Stanley Research

Exhibit 18: Student loan by employment status



Source: AlphaWise, Morgan Stanley Research

Endnotes

1 Household debt service ratios is the total quarterly scheduled consumer debt payments divided by the total quarterly disposable personal income.

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