**The Sale of Student Loans**
Andrew McGettigan, December 2013

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**Summary**

There are three declared aims behind the proposed sale of student loans:

- To lower Public Sector Net Debt;
- To ‘derisk’ the government’s balance sheet;
- To raise funds to finance an expansion of undergraduate places.

A sale would be subject to two tests:

- That it represents value for money;
- That the sale does not lead to detrimental conditions for existing borrowers.

In order to ensure the last condition is met, the government are likely to use a ‘synthetic hedge’ to compensate purchasers with contractually determined payments over the post-sale life of loans, especially with regard to the current interest rate terms.

This complicates any assessment of value for money since headline price needs to be set against the value of the income stream sold and any additional payments going the other way (these may be very difficult to assess given the timescales involved). A more easily determinable loss may be preferred to ongoing fluctuations in value. There is unlikely to be a clear test of ‘taxpayer value for money’.

Previous sales in the late 90s has so far lost £250m on a sale that raised £2billion then.

The aims may therefore be achieved at a price. A reduction in PSND is possibly owing to the manner in which the statistic is constructed but the benefit is to an accounting presentation today, not necessarily an improvement of the balance sheet over the longer term. It is very unclear how the sustainable expansion of undergraduate places can be achieved through such sales, since it is not clear that the programme could be repeated after 2019/20.
**Briefing**

In the 2015/16 Spending Round, an accompanying infrastructure plan announced the government’s intention to proceed with the sale of roughly £10billion of income contingent repayment loans. December’s Autumn Statement reaffirmed those plans with the sales to commence towards the end of 2015/16, run for five years, and raise £10-15billion with a ‘central estimate of £12billion’.  

At present, the face value of outstanding loan accounts is equivalent to £46billion (as at 31 March 2013), though the ‘fair value’ recorded in the accounts is £31bn – recognising that not all of the outstanding balances are expected to be repaid. The government may therefore be viewing to sell up to half of these outstanding loan accounts and may see ‘market appetite’ as the only limit to volume.

The sales would offer ‘pre-Browne loans’: outstanding loan balances made to those commencing study for the first time between 1998 and 2011. The recent National Audit Office report into the Student Loan Company confirms what was in the 2011 Rothschild feasibility review: whole ‘cohorts’ would be offered at auction beginning with the accounts of those who commenced repayments between 2002 and 2004. Likely purchasers are thought to be pension funds and insurance companies.

A BIS factsheet issued on Monday 9 December stated:

> “a final decision to go ahead with the sale has not yet been taken. Any decision will require a full assessment of the value for money to the taxpayer of selling the loans against the cost to Government of retaining them.”

NAO reported that the current model used to estimate repayments ‘is not fit for the purposes of a sale of the income-contingent repayment loan book’ (§4.14). A new model will be developed by Spring 2014. This may represent the ‘outstanding hurdle’ to the feasibility of the sale programme as described in the 2012/13 BIS accounts.

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1 Accompanying figures appear to show that estimate as £11.5billion: with £2.3billion assumed received in each of the five years of the sale programme.

2 These were maintenance loans only until tuition fee loans became available to those starting in 2006.

3 I have read and, with the help of False Economy, partially transcribed the ‘Rothschild review’, the full title of which is: Project Hero: updated views on feasibility (22 November 2011 – Rothschild on behalf of the Department for Business, Innovation & Skills).

4 National Audit Office Student Loan Repayments, November 2013, §1.10. HMRC and the Student Loan Company would continue to collect and administer loan payments under a servicing agreement. This is a different approach to that taken in the earlier sales of 1998 and 1999.

5 This current model, developed by Deloitte in 2011 and dubbed, ‘Hero’, has cost BIS £400 000.

6 “BIS aims to have developed an improved forecasting model by spring 2014. In 2012, BIS commissioned Deloitte, at a cost of £95,000, to improve the methodology for forecasting future earnings profiles. In January 2013, Deloitte proposed an updated approach, which uses more years of borrowers’ earnings histories to inform projections. Having taken advice from internal and external experts, BIS decided not to implement Deloitte’s proposal. BIS is instead developing a new model, with a different approach to borrowers’ earnings histories, using their own analysts. This upgrade focuses on graduate earnings paths – the changes in earnings from one year to the next – and also updates other assumptions such as the probability of death or disability.” (§4.15)

7 There, the ‘monetisation’ project is rated ‘amber/red’ on BIS’s internal colour coding for ‘delivery confidence’, with green indicating ‘go’. BIS Departmental Accounts 2012/13, p. 92.
If these plans are consistent with what was outlined in the Rothschild report into the feasibility of loan sales, then such a volume of sales could only be achieved by circumventing the current interest rate terms, whereby borrowers pay the lower of the bank base rate plus 1 percent or current RPI.

Rothschild estimated that only £1-2bn could be sold with this ‘cap’ in place; but over £10bn with it removed.\footnote{‘We presume the Government’s core objective is to sell £10-£20bn of the student loan book over 3-5 years at a real yield at or below 3.5%. … We believe that, without the Base Rate +1% cap such an objective should be capable of being achieved.’ Rothschild} Rothschild, writing in late 2011, was urging a sale in October 2012.

The Autumn Statement confirmed that “Borrowers’ loan terms will be fixed prior to a sale. The interest rate charged will remain at the Retail Prices Index (RPI) or base rate plus 1%, whichever is lower” (§2.16). Several potential investors told Rothschild that they could not purchase the loans with the cap in place. It is then likely that the government will proceed with Rothschild’s alternative recommendation of a ‘synthetic hedge’.

**Synthetic hedge**

A synthetic hedge is designed to protect potential purchasers from the continuing and future effects of low bank base rates. At 0.5 per cent since 2009, this means that interest is accruing on borrowers’ accounts at 1.5 per cent rather than the current RPI rate of 3.3 per cent.

Rothschild state, the risk of interest being below inflation:

… is best taken by Government (they can afford it, assess it and ameliorate it better than any other); second best is it being taken by graduates (their earnings are more likely to reflect inflation than Base Rate); and lastly by investors who want inflation protection and for whom the cap is a significant distraction. [my emphasis]

So what is a ‘synthetic hedge’? It artificially replicates the removal of the interest rate cap for the purchasers of the loans.

The loans would be sold \textit{with the interest rate cap in place}, but the government would compensate purchasers by entering into a contractual obligation to make additional payments \textit{after the sale} to cover the ‘the differential between the cash flow actually received for the relevant cohort and the estimated cash flows that would have been received had the Base Rate cap been removed at the time of sale’.

This ‘hedges the impact of the Base Rate cap’ and guarantees that investors will benefit from an effective interest rate that is never below RPI or zero, taking whichever is the higher.

In sum, if RPI is below the bank base rate + 1% over the post-sale lifetimes of loans, then there are no payments from the government to the purchaser.

But when RPI is higher, as now, then the loan balances are accruing less interest with the effect that some borrowers \textit{will repay what they have borrowed earlier} than would otherwise be the case had the cap been removed. The interest rate spread is currently 1.8 percentage points (2.1 percentage points last
The ‘hedge’ proposes that the investors would receive additional cashflows towards the ‘back end of the maturity profile’ to represent the final payments that would otherwise have been made.\(^9\)

For example, a borrower may pay off their account in 2035 rather than 2037 thanks to the low bank rates: the government would instead make payments for that borrower to the purchaser for those ‘missing’ two years. For the purchaser, it is as if the government had changed the terms for borrowers, but the government makes those payments, not the borrower.

Note that, unlike the subsidy on previous loans, which have been made annually since purchase and which will be discussed below, these ‘hedge’ payments will not commence until several years into the future (those on the earliest versions have their balances wiped at retirement) and will be concentrated into a smaller period.

It is difficult to estimate what such a contract would cost government, not least because of the impossibility of predicting macroeconomic features like inflation and interest rates decades hence. However it is possible to glean information from recent BIS annual accounts that will enable us to get a feel for the value of what is proposed.

In the last three financial years, the department has made three ‘reserve claims’ to the Treasury. These reserve claims amount to £7.35bn (of which roughly £7bn had been spent by the end of 2012/13).\(^{10}\)

This represents additional budgetary resource – over and above what resulted from the 2010 Comprehensive Spending Review. The claims were required to deal with:

- the ‘permanent impairment’ inflicted by the bank base rates on the value of the outstanding loan accounts;
- changes to the assumptions used in valuing the loans as the full extent of the recession became apparent.

This entry from the 2011/12 accounts gives a flavour of the issue:

The decrease [in loan book valuation] was mainly the result of notional (non cash) costs in respect of impairments and changes to assumptions made to the value of the student loan book which amounted to £3,284 million in 2010-11 and £2,205 million in 2011-12 (a reduction of £1,079 million). A non cash Reserve claim totalling £2.9 billion was made in 2011-12 (£2.7 billion in 2010-11) to cover further impairment of the value of the student loan book which was largely due to economic factors, mainly the continuing unusually low interest rates.\(^{11}\)

A year later, with the base cap continuing, we can find an explicit estimate of its effect:

From 2012-13, the impact of the base rate cap on these loans is included within amortisation, as the existence of the base rate cap in effect reduces the amount of interest received and increases the level of subsidy provided by the Government. If the base rate cap

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\(^9\) ‘For any individual borrower, the impact of the Base Rate cap will, in any event, only have a cash flow impact in the last years of the loan or in the level of balance written off.’

\(^{10}\) £1.75 billion in 2012/13; £2.9 billion in 2011-12; £2.7 billion in 2010-11.

\(^{11}\) BIS annual accounts 2011/12, p. 58.
was not in operation with effect from 1 April 2012, the value of the student loan book would increase by £1,600 million.\textsuperscript{12}

That is, BIS estimates that the interest rates have led to the writing down of the value of the loan book by £1.6bn for the one year – 2012 to 2013.\textsuperscript{13} That reflects lost future repayments. Future hedge payments would compensate purchasers under similar scenarios.

This points to a key structure of any sale: in return for an upfront payment the government would forego all associated future income streams and commit to making hedge payments. This affects any assessment of ‘value for money’ in terms of headline pricing: the cash received upfront must be netted against both lost earnings and any form of subsidy payment. Indeed, Martin Wolf has called the sale of the loan book ‘economically illiterate’ as any feasible sale is likely to make a long-term loss to the government (since it has the lowest cost of borrowing and therefore ought to get most value from the same income stream).

We can illustrate this by considering the previous loan sales from 1998 and 1999. Those sales resulted in £2billion upfront payment but once the continuing subsidy and foregone payments were factored in, then the government knew it was making a loss on the deal.

Those deals, which last until 2028 and 2029, include compensation for deferments that lead to write-offs.\textsuperscript{14} The contracts determining annual subsidy payments were constructed around LIBOR, which has been subject to its own controversies as well as being lower than expected since 2009, and compensate the purchaser for maintaining the terms on which the loans were first issued.

BIS accounts confirm a liability on the books relating to the ‘student debt sale subsidy’: the liability represents:

\begin{quote}
‘the additional cost to the Core Department arising from the Government subsidising the purchaser of the debts \textit{beyond the cost that the Government would have incurred had the debts remained in the public sector}.’ (ibid. my emphasis)
\end{quote}

That figure now stands at £252million in present value terms (£218million in 2012; £191million in 2011).

The Aims of a Sale

\textsuperscript{12} BIS annual accounts 2012/13, p. 194.

\textsuperscript{13} I would guess that this additional reserve required to cope with loans illustrates one reason why the Treasury has refused the request to lower the ‘discount rate’ used for evaluating the present value of loans. The rate is currently 2.2% + RPI which is significantly higher than the government’s current cost of borrowing – this rate represents an internal ‘hedge’ in government finances against overly optimistic assessments of graduate repayments.

\textsuperscript{14} “Borrowers who earn less than the repayment threshold are eligible to apply for deferment of repayments and under the contracts the Core Department is liable to pay compensation to the purchaser of the debt where this occurs. There are also small adjustments to the claim for cancelled loans and first losses. The first loss is a risk sharing arrangement for the most overdue sold loans (over two years without a repayment) where subsidy is paid in relation to these loans, up to a cap defined in the contracts”. BIS 2012/13 Annual Accounts, p. 236
Given these issues, what is motivating a sale?

Rothschild states: ‘The main objectives of the monetisation are to reduce [Public Sector Net Debt] and the Government’s risk exposure to the loans and ensure monetisation represents value for money.’\(^\text{15}\) To this we can add the financing of an expansion in undergraduate places, which was announced in the Autumn Statement, though the details and implications for sustainability are extremely unclear at present.

‘The additional outlay of loans over the forecast period will be more than financed by proceeds from the sale of the pre-reform income-contingent student loan book. Taking the two together, public sector net debt by 2018-19 will be lower as a result.’ (§1.203)

The Institute for Fiscal Studies suggested that this first claim – that public debt will be reduced – is ‘economically nonsense’ as selling an asset for what it is worth does not improve public finances.

However, PSND is constructed so as to exclude ‘illiquid financial assets’. Student loan accounts fall under this category. This means that the positive value of the loan book – as an asset it represents money owed to the government – does not ‘score’ in PSND. Only the negative side of the system does: the borrowing the government makes to finance loans in the first place. That means that in PSND only the liability associated with student loans counts.\(^\text{16}\) This means that cash raised from any sale could be set against the annual net cash requirement and used to reduce PSND.

The headline statistics – the debt and the deficit – are used to present macroeconomic competency to the public and so there is a political gain to be had from selling the loans even if it means foregoing significant income streams, committing future governments to subsidy payments and thereby resulting in a net long-run economic loss.

The government had been seeking a ‘repeatable programme of sale’ that would allow each year’s new loan outlay to be sold on to investors via a mediating financial product.\(^\text{17}\) This ‘originate to distribute’ model has been abandoned for the time being, as the new higher loans are deemed to be ‘too risky’, and instead the government has been concentrating on a ‘retrospective’ sale of loans issued in previous years.

From the perspective of debt reduction, the significance of the planned sale programme is thereby greatly reduced - roughly £12bn of new loans will be issued each year from 2014/15, dwarfing a sale that is expected to raise only £12bn over five.

\(^{15}\) Just prior to Spending Round announcement, Baroness Garden of Frognal – “Any future sale of income-contingent repayment student loans would take place only if it reduced the government’s risk exposure to the loan book, represented value for money for the taxpayer and ensured protection of borrowers.”

\(^{16}\) “Public Sector Net Debt is calculated as government liabilities less liquid assets. Student loans are not a liquid asset, so they do not feature in the calculation. However, as noted above, government finances loans to students by issuing debt instruments (gilts), that are scored as government liabilities, which increase PSND accordingly. ... Insofar as government will need to increase its liabilities by issuing more debt instruments, this will push up PSND.” Office for National Statistics spokesperson in Autumn 2011 (personal communication).

\(^{17}\) 2011 White Paper §1.41 ‘We want to find a solution that will manage all current and future ICR loans on an ongoing basis (unlike the one-off sales of the late 1990s).’
The latest Economic & Fiscal Outlook, published to accompany the Autumn Statement, estimates that £17.4 billion of new loans will be issued in one year, 2018/19, while repayments languish at around £3 billion (significantly reduced since a portion of that income stream will be going to the purchasers instead of the government). Additional borrowing is required for every year of such a shortfall between annual outlay and annual receipts.

The OBR was predicting that these liabilities will break £100 billion before the loan scheme reaches ‘steady state’ (when ‘cash in’ matches ‘cash out’) circa 2035. This estimate can now be revised upwards owing to the decline in repayments received by government following a sale programme. Without a countervailing policy to raise graduate repayments receivable by the government, such as by freezing repayment thresholds after 2015, that ‘steady state’ is now even further off with the peak impact on net debt likely to be significantly higher.

Turning to the second reason for seeking a sale: reducing risk exposure means attempting to avoid unforeseen additional payments: the previous sales did not achieve this.

At present, the main concern is to remove the risk associated with lower than anticipated repayments. Repayments have been poor and, as emphasised by NAO, repeatedly and significantly lower than projected.

According to Rothschild’s own estimates on pricing, the accounts of those cohorts graduating since 2009 into the recession would achieve a lower sale price given the effects of such bad luck on future earnings. The outstanding balances for those cohorts grew in the last few years despite the low interest rates – indicating how low their repayments have been.

Those graduating with loans in 2012 owe £5.243bn in total at an average of £18,740 each. The 2015 cohort will owe twice that. In David Willetts’s most recent public talk, at the LSE on the 50th Anniversary of the Robbins report, he admitted that the ‘RAB charge’ for new loans is now thought to be somewhere ‘between 35 and 40 per cent’.

One sign of growing concern around the sustainability of loans supporting higher fees is found in the most recent BIS accounts. For the first time, the Comptroller and Auditor General expressed concern about the ‘potential for significant changes in the valuation of student loans to occur’.

**Emphasis of matter – uncertainties inherent in the valuation of student loans**

Without qualifying my opinion, I draw attention to the disclosures made in notes 1.31 and 20.1 to the financial statements concerning the uncertainties inherent in the valuation of student loans. As set out in these notes, given the long term nature for the recovery of loans and the number and volatility of the assumptions underpinning their valuation, a considerable degree of uncertainty remains over the recoverable amounts of the loans issued. Significant changes to the valuation could occur as a result of subsequent

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18 “Selling the loan book reduces repayments over the latter years of our medium-term forecast, by just under £1 billion in 2018-19, and beyond, whereas removing the numbers cap increases forecast outlays by around £2 billion by 2018-19.” OBR Economic & Fiscal Outlook December 2013, §4.145 and Tables 4.31 & 4.32.

19 This was further confirmed in a parliamentary answer from David Willetts on 9 December 2013. Hansard [http://www.publications.parliament.uk/pa/cm201314/cmhansrd/cm131209/text/131209w0001.htm#13120934000016](http://www.publications.parliament.uk/pa/cm201314/cmhansrd/cm131209/text/131209w0001.htm#13120934000016)
information and events which are different from the current assumptions adopted by the Department.\textsuperscript{20}

The tenor of these problems with the loans indicates reasons why the government might want to sell. But who would want to buy under such circumstances? Feedback from buyers indicates that they would offer prices lower than the government’s own valuation of the loans.

The final objective, ‘value for money’, is then perhaps most significant. The test is a ‘comparison of expected value of achieving the sale with the expected value of retaining the assets over their life’. This comparison does \textit{not} mean that the sale must generate more value. Indeed, low prices may enable investors to familiarise themselves with the ‘product’ and prepare for more significant sales in future. The government may be prepared to lose money for the sake of an improved balance sheet. It is just that it should not be \textit{too far below the current ‘fair value’ recorded in the accounts}.

What upfront price could it hope to achieve? In 2011, Rothschild estimated 63p per pound of ‘face value’ with the current base rate cap in place. At the time, the fair value of loans on the government’s accounts was booked at roughly 70p per pound of face value (it has since dropped to roughly 67p overall). This indicates a significant variance between sale price and book value.

In order to raise £10-15billion of proceeds, we might be looking at a loss in the region of hundreds of millions. Obviously, changing repayment terms to boost a sale price would also increase the value to the government of keeping hold of the loans.\textsuperscript{21}

The bigger question is whether an \textit{ongoing} sale ‘solution’ can be achieved and whether it would entail a similar scale of loss. Rothschild are explicit: ‘One of the consequences, however, of selling the ‘pre-Browne’ loans on their own is probably to defer the sale of the \textit{much riskier}, ‘post-Browne’ loans until c 2020’ [my emphasis].\textsuperscript{22} They believe that a track record of borrower behaviour needs to be developed in relation to the new loans ‘to \textit{gain a better understanding of these assets}’.

Significantly, we do not know how repeatable a sale programme is, as it depends on market appetite. Hence funding an expansion of places (and loans issued) on the back of sales appears inherently speculative.

\textsuperscript{20} 2012/13 BIS annual accounts, p. 102.

\textsuperscript{21} Assessing the synthetic hedge is further complicated by the fact that this would generate future cash outflows whereas the amortization being recorded as a result of the low bank rate is a non-cash impairment made now.

\textsuperscript{22} Note that this date was based on the understanding that sales would commence in 2012/13.