

The accounting and budgeting of student loans

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About the author

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Foreword

Lord Palmerston said only three people understood the Schleswig-Holstein question: ‘the Prince Consort, who is dead—a German professor, who has gone mad—and I, who have forgotten all about it.’

It sometimes feels as if only three entities understand the notorious ‘RAB charge’: HM Treasury; the Department for Business, Innovation and Skills; and Dr Andrew McGettigan, the author of this HEPI blue book.

Elsewhere, misunderstandings abound. For example, the RAB is generally regarded as referring to the government’s loss on student loans arising from the progressive repayment terms. The pages that follow reveal that is only half true at best.

Although understanding of how student loans appear in the national and departmental accounts is poor, it is crucial to issues like the future of student finance, any sale of the student loan book and even the size of the nation’s debt.

The currency of politics is killer facts and the pages that follow include many of them. While the overall story of how student finance appears in the accounts is not straightforward, the core argument of this analysis is crystal clear: policymakers risk prioritising private-sector accounting methods over good public policy.

Nick Hillman
Director of HEPI

The accounting and budgeting of student loans

Executive summary

English higher education policy debates revolve around student loans and estimates of graduate repayments. Yet little attention has been paid to how student loans feature in the national and departmental accounts.

This report sets out to fix these shortcomings by explaining some of the technicalities shaping the contours of current policy. It argues that accounting and headline statistics are driving policy – for example, with regard to any future sale of student loans.

How do student loans work?

Student loans for home and EU undergraduates in England have long lifetimes – around 35 years. Due to their income-contingent nature, they display unfamiliar repayment profiles compared to other loans, with the majority of repayments appearing in the second half of their life. This produces great uncertainty when estimating their value that needs to be managed through good accounting with a long-range view.

Student loans and the national accounts

The headline public sector finance statistics for the deficit and the debt treat student loans unlike other items. Classed as

'financial transactions', annual loan issuance and any repayments are excluded from the expenditure and receipts that determine the current measure of the deficit. They do however affect the main measure of debt. Student loans are therefore not 'off balance sheet'. It is the growing impact of student loans on the UK national debt that is driving the search for ways to monetise student loan accounts by selling them off.

Student loans and departmental accounts

In England, student loans are the responsibility of the Department for Business, Innovation and Skills (BIS). The loans appear as assets in BIS's departmental accounts. A fair value is calculated by estimating future repayments, which are discounted to reach a net present value.

The loans held by BIS are not worth as much as the money used to create them: their value is impaired. So, each year, the Treasury allocates specific, ring-fenced resource to cover the loss on any student loans issued that year. This is known as the Resource Accounting and Budgeting or RAB charge.

When downward revisions to projected repayments for existing loans occur, BIS must seek additional resource from the Treasury to cover what is known as a 'stock charge'.

A key factor in determining the size of the impairments is the discount rate used. This is set centrally across government for financial reporting and budgeting and, at present, is 2.2 per cent above inflation. That is higher than the government's

actual cost of borrowing via gilt sales. So a RAB charge of 45 per cent cannot be accurately presented as the government's loss on loans without qualification. The loans are probably undervalued on BIS's books.

This issue of undervaluation applies even more to the value-for-money tests necessary for selling student loans, when the calculation is derived from a higher discount rate of 3.5 per cent plus inflation.

If the discount rate were lowered, as some have lobbied for, the RAB charge allocation provided to BIS would be restated in line with the revised discount rate. That is, the allocation and the impairment would both be lowered. So, while it would improve the published figures for the loss on loans and might alter political debate, it would not solve all the challenges associated with managing the loan book.

Student loans and sustainability

The sustainability of the student loan system is determined by whether BIS has sufficient resource to cover the impairments. A major fiscal challenge was averted in 2013/14 via a retrospective change to the accounting and budgeting rules, which allows higher loan impairments to be smoothed out over the following three decades.

The new accounting conventions provide a risk-sharing agreement between the Treasury and BIS, which requires BIS to increase projected loan repayments or face year-on-year cuts to other spending. It is no longer reasonable to argue

that losses on loans are irrelevant today, since they translate into a cash sum that must be covered from elsewhere.

This new risk-sharing agreement may incentivise BIS to change student loan repayment terms. That could undermine public goodwill towards higher education and bring more fundamental questions about sustainability to the fore.

Conclusion

The accounting and budgeting treatment of student loans is complex. Attention to detail is vital when discussing the related policy. Despite recent changes to the relevant conventions, the current levels of projected loan repayment still leave a problem for BIS. How will they respond to the new incentives put in place by the Treasury?

Headline statistics and accounting conventions should not be mistaken for natural phenomena. They reflect accumulated decisions and revisions. We need to be sure that they are not distorting policy. Loans need good accounting conventions to deal with their volatility. But the accounting conventions should be designed to reflect and manage responsibly the ends higher education policy pursues.

If we are making policy fit the accounting without critical scrutiny, as seems to be happening, then something has probably gone wrong.

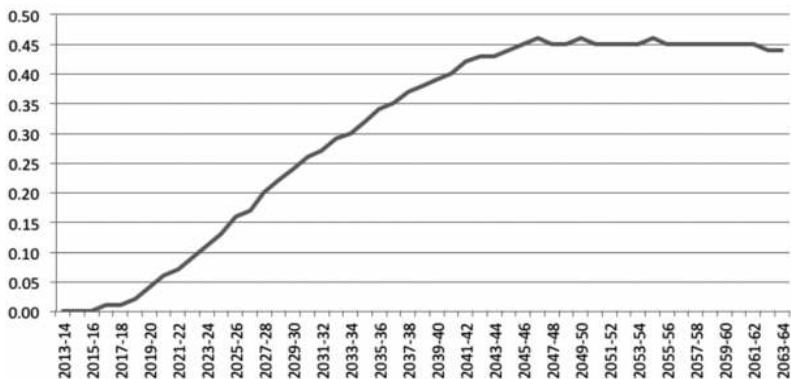
Introduction

The reforms to English undergraduate finance introduced in 2012 were consistent with austerity measures while protecting university income: higher fees, and hence higher loans, replaced around £3 billion of teaching grants paid direct to higher education institutions.¹

Estimates of the repayments associated with those loans have dominated policy discussion. The official estimate of the value of the repayments has been repeatedly reduced, which has fed a wider debate about the overall sustainability of the fee-loan scheme.

There will be low levels of repayment over the first decade or so of the new system. Only after 2025 do the projected repayments rise to significant levels, before plateauing after 2040 at roughly £8 billion in today's terms.

Annual student loan repayments (% of GDP)



Office for Budgetary Responsibility, *Fiscal Sustainability Report*, July 2014, p.178

Annual repayments in 2045 are expected to remain below annual outlay, which means there is always projected to be a shortfall. This deficit though is presumed to be smaller than annual GDP growth, which explains why the contribution of student loans to public debt is projected to plateau from the 2040s.²

Government borrowing makes up any annual shortfall between repayments and new loans issued. Although the extra cash outlay on loans is broadly similar to the grant spending it replaced, there are stark differences in the accounting treatment. This enabled the Coalition to preside over a lower deficit as a result of the reforms.

This presentational boost relies on future repayment income coming in roughly as expected. But the nature of income-contingent loans means it is difficult to predict the returns in advance. How that uncertainty is managed through budgeting and accounting underpins the overall sustainability of student finance.

This pamphlet outlines how student loans feature in the national and departmental accounts and explains some of the current contours of Treasury and BIS policy. The rules have changed more than once since 2010 and much of the debate has yet to catch up, particularly with respect to questions of sustainability. Indeed, much policy discussion has been based on fundamental misunderstandings of the accounting.

So this pamphlet aims to set the framework for a more productive debate. Although it discusses government plans

to sell student accounts to the private sector, that theme is not treated here in detail but is covered elsewhere.³

The chapters that follow will question whether the accounting conventions in place are appropriate or whether they have moved too close to private-sector accounting practices, ensuring loans will always score better than other approaches to higher education funding. If accounting and some very narrowly constructed figures are leading the policy, perhaps we have gone wrong at root?

Chapter 1 explains how student loans work. Chapter 2 considers how student loans relate to the UK national accounts, including the measures of deficit and debt. Chapter 3 turns to England and BIS's departmental accounts and budgets. It examines how the Treasury allocates resource to BIS to cover the impairment on student loans. Chapter 4 looks at what happens when the valuation placed on existing student loans in departmental accounts changes, as has occurred in recent years.

Chapter 1

How do student loans work?

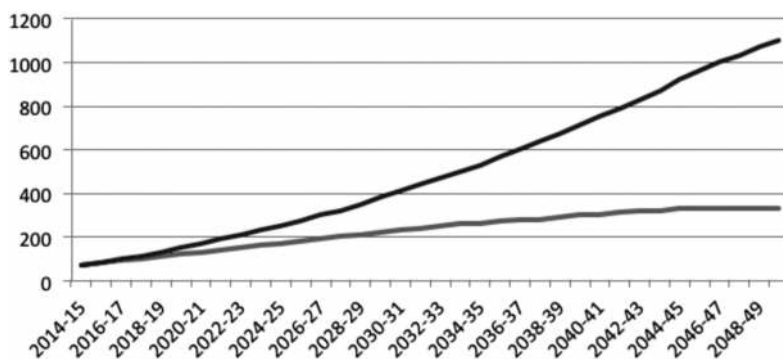
In general, fixed period loans are familiar. If I borrow £1,000 and agree to make equal monthly repayments for ten years. I commit to paying the same cash sum each month. The value of the monthly payment changes in real terms but the cash amount is fixed. After ten years, my balance clears and my payments stop.

Income-contingent repayment loans, as used in the UK for student loans, are different. Monthly repayments are not determined by the amount borrowed nor the period of repayment. Payments are determined instead by the debtor's income. There are five variables determining how long they continue:

1. the initial loan balance, currently predicted to average around £44,000 at graduation;
2. the repayment threshold, set at £21,000 for 2016/17;
3. the repayment rate, which is 9 per cent of income above £21,000;
4. the interest on outstanding balances, ranging from RPI to 3 per cent plus RPI; and
5. the write-off period, thirty years from the April after leaving undergraduate study.

The chart below shows official projections of total outstanding balances over the next four decades as new loans are created, interest is added to outstanding loans and repayments are made. The face value in today's terms is expected to peak at £330 billion before the first write offs kick in. In future cash terms, the total amount owing will have crossed £1 trillion by that point.

Projected total balances on outstanding student loan accounts (£bn)



top line - outstanding student loan balances in cash terms

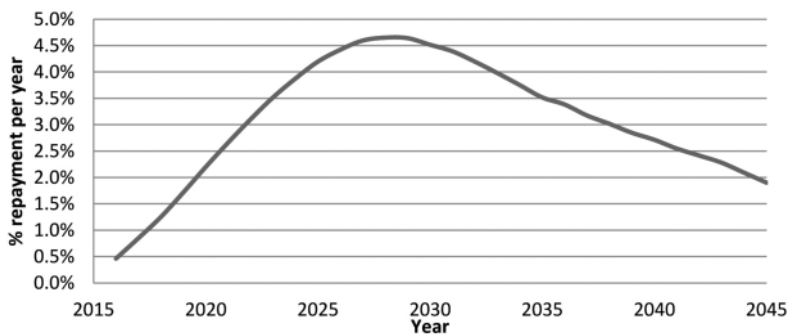
bottom line - outstanding student loan balances in 2014 terms

Source: Hansard, 18 June 2014, c656W.

The face value of the loans is the nominal balance owed to government via the Student Loans Company. This is not the same as what these loans are worth to government – that fair value is determined by the estimated repayments the accounts will generate. As the majority of individual loan accounts are not expected to be paid off in full, these two values (face value and fair value) are projected to diverge.

Estimating repayments is challenging with income-contingent loans. But the chart below based on figures from the Institute for Fiscal Studies illustrates when repayments from those starting university in 2012 are projected to be made in real terms. It is an unusual repayment profile, with the majority of repayment value coming after 2030. With a fixed-period loan, the highest value repayment would be the very first one with each subsequent payment generally eroded in real terms by inflation.

Real repayment per year from 2012 undergraduate cohort



Source: Neil Shephard, *The actual financing costs of English higher education student loans*, 2013 (<http://www.economics.ox.ac.uk/materials/papers/12748/2013-W06.pdf>).

The student loan scheme brings a peculiar form of uncertainty to the fore: in estimating loan repayments, we are estimating graduate incomes thirty years into the future as well as the repayments those incomes generate. This means the income-contingent repayment loan scheme has a qualitatively different level of uncertainty to other loans, not just

that we are making projections into the distant future. This explains why the Auditor General, who reviews the government's accounts, has repeatedly included an emphasis of matter in BIS's annual financial report:

*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 information and events which are different from the current assumptions adopted by the Department.*⁴

Indeed. In 2013/14, a major recalibration to the official model for estimating repayments had to be made. Given such alterations to the fundamental projections, the accounting needs to be adequate to that uncertainty and to reflect clearly what governments are trying to achieve.

Student loan accounting begins with the interaction of four parties: the Treasury; the gilts market; BIS; and the student loan borrowers. The Treasury borrows money by issuing gilts. It then lends that money to BIS, which lends it to students via the Student Loans Company.

Since the Government has to borrow to create loans, both an asset and a liability are created. From the Government's perspective, outstanding student loan accounts are the asset: they are money owed to government by borrowers. The gilts issued are the liability: money the government owes.

The value of each is determined by the value of repayments. For the asset (the student loan), the borrower makes mandatory monthly repayments determined by their income.⁵ For the liability (the gilts), the government makes payments every six months and repays the principal when the bond reaches maturity.

In theory, the net position of the government is the value of the asset and liability offset against one another. But, in practice, there is a big difference between how the Treasury and BIS treat such things.

Chapter 2

Student loans and the national accounts

Each year, the government issues billions of pounds in student loans and receives repayments on outstanding loan accounts. These cash flows are excluded from the expenditure and income measures used to calculate the public sector deficit, which is at present based on the current balance (the difference between expenditure and income, excluding capital expenditure).

Since loans create assets projected to generate cash through future repayments, their creation does not count as spending. They are treated instead as financial transactions that create capital in the classical sense of a stream of future income. In the distant past, loan outlay was classed as expenditure and repayments were receipts, as with taxation and spending. But the Dearing review of 1997 recommended this should change for higher education and that happened in the early 2000s.⁶

However, each year the amount of cash lent out in new student loans is higher than the repayments received, meaning student loans do draw on the Public Sector Net Cash Requirement (PSNCR). This is a broader measure than the deficit and is the driver of national debt since the government opts to finance its cash requirements by borrowing. The table overleaf sets out the impacts on PSNCR between 2014/15 and 2019/20. For example, in 2019/20, the additional borrowing needed to cover the shortfall between loans issued and repayments made is estimated to be £13.9 billion.

Projected loan outlay & repayments (£ billion in cash terms)

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
New loans issued	12.1	13.7	14.8	15.5	16.0	16.5
Repayments	2.3	2.4	2.6	2.5	2.3	2.5
Shortfall	9.8	11.2	12.2	13.0	13.7	13.9

Source: Office for Budgetary Responsibility, Economic & Fiscal Outlook, March 2015, Table 4.33

Loans and the headline public sector finance statistics

Although they do not appear in the deficit, student loans and the borrowing associated with them are on the government's books from day one. Money goes out of the door today, even if it is not classified as regular spending. But the position expressed by the headline statistics is worse than might be expected.

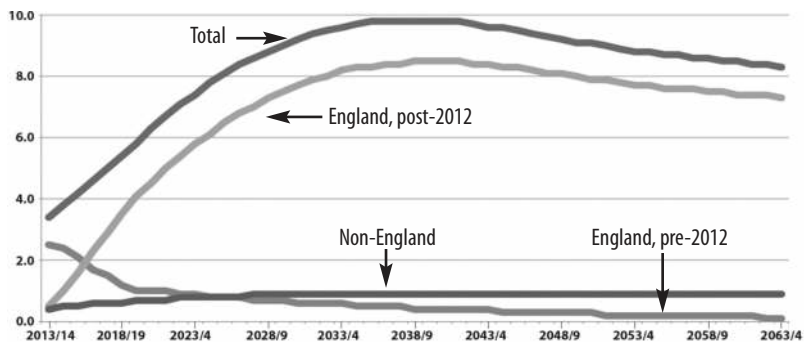
Public Sector Net Debt (PSND), the headline measure of the national debt, generally includes assets and liabilities. So one might assume that student loans created (assets) would net against the liabilities (borrowing) taken on, with positive and negative both scored. However, the Office for National Statistics considers student loans to be an illiquid asset, meaning they cannot be converted into cash easily (in other words, sold).

Illiquid assets are excluded from the PSND calculation so the impact on the headline statistics is one-sided. Only the liability, the negative side, is included. The asset, the loan book, does not appear so it does not offset its associated liability in this particular measure.

The impact of student loans in the PSND figure is therefore overstated from the perspective of the general financial position. This means any effect associated with a loan sale is presentationally beneficial in the short term, as it would reduce the main measure of the national debt. Cash received from purchasers today counts as a liquid asset and so would offset liabilities to reduce PSND, while the projected future repayments sold in return did not score in the first place.⁷

Student loans have historically been a small component of public debt but, with issuance rising to £16.5 billion in 2019/20 and repayments still languishing at £2.5 billion, the government must borrow large sums annually to pump-prime the new funding regime. The chart below shows the contribution of student loans to public debt rising to nearly 10 per cent of GDP. Although such long-range projections may seem somewhat fantastical, they indicate the scale of the impact on PSND.

Impact on Public Sector Net Debt as a result of student loans (% of GDP)



Office for Budget Responsibility, *Fiscal sustainability report*, 2014, p.176

The normal understanding of the deficit and debt does not apply in this circumstance: reducing the deficit slows down the growth of debt if one does not consider financial transactions. But the switch from grant to loans lowered the deficit without altering the main measure of debt, the PSND, in the short run.

At the end of the 2014/15 financial year, PSND (excluding measures taken to rescue banks) is expected to be around £1,500 billion or over 80 per cent of current GDP. Long-range intentions in the Treasury are to reduce the stock of debt back to levels seen prior to the financial crisis: below 40 per cent of GDP, which was formalised as a target by the last Labour government. Were debt overall to be reduced to that level, then student loans will have a big impact on PSND.

One projection by the Office for Budget Responsibility (OBR) has public debt dropping to 54 per cent of GDP in the mid-2030s, by which point debt associated with student loans will have climbed to nearly 10 per cent on the same measure.⁸ This implies that student loan debt may come to contribute around one fifth of PSND at that point.

The OBR has translated the chart's percentage figures into cash terms: 'the direct flows will add 5.4 per cent of GDP to net debt in 2018-19 (£88 billion), rising to 9.8 per cent of GDP by the mid-2030s (£162 billion), and then falling to 8.3 per cent of GDP in 2063-64 (£137 billion).'⁹ The current system does not reach operational maturity until 2040, by which time over £100 billion will have been added to the PSND measure.

Having debt on a downward path is seen as important to the Treasury not just because it is used to signal macroeconomic competence to the public, but also because it signals credibility to the markets. Market expectations of future debt are thought to matter. The Permanent Secretary to the Treasury, Nicholas Macpherson, gave a lecture early in 2014 where he outlined his department's thinking:

*it is a long time since the UK experienced a 'gilts strike'. But in my view there will always be inflection points where a further increase in borrowing will result in a much bigger increase in funding costs as a number of Eurozone countries have found to their cost. Ex ante it is difficult to know where these inflection points are, which makes the case for erring on the side of caution.*¹⁰

It is also accepted that the government would like to lower debt interest payments as an item of expenditure, as they made up £52 billion in 2014/15 or 7 per cent of all expenditure. They also want the capacity to absorb future economic shocks along the lines of 2008/09. In general, these considerations are thought to outweigh the opportunity presented by the current (historically low) cost of borrowing.¹¹ The current fiscal position lies outside the Treasury's comfort zone.

Official documents explain that a sale of student loans would reduce PSND and de-risk the balance sheet. The uncertainties around student loan repayments mean that a government might prefer to take the cash from a sale now even at the cost

of precipitating a loss today bigger than that projected in the long-run.¹² A smaller known loss is less risky than the higher returns thought to result from holding on to the loans. The current sale plans focus on loans issued to those who commenced undergraduate study before 2012, but one aim of the sale is to prepare the way for a sale of 'post-2012' loans as per the original intentions of the 2011 White Paper.¹³

The treatment of student loans in the national accounts is therefore set up in such a way as to favour an undergraduate finance model that replaces grants with loans and then sells those loans on. The liabilities associated with issuing loans are immediately offset by sale proceeds and the impact of higher education finance on both the deficit and on PSND can be dramatically reduced. The Treasury appears to be prepared to tolerate additional long-run losses – as it did with the Public Finance Initiative and does with PFI 2.0 – to minimise the capital commitment on the national balance sheet.

Alternative approaches are disadvantaged by the accounting treatment. Labour's lengthy internal debate before the general election over whether to commit to lowering the maximum full-time tuition fee for home and EU undergraduates was fundamentally a decision on whether it could limit the impact of a lower fee cap on the deficit. In fact, no new money would be required for a reduction in fees between 2015 and 2020: the issue is switching cash used to create loans with cash used to spend on grants. Switching over £2 billion between those two classifications increases the deficit

by that full amount over the next five years regardless of the level of repayments associated with the higher fees and loans.

In the end, Labour's policy sought to align additional grant expenditure with receipts generated by new restrictions on pensions tax relief (supplemented in their election manifesto with measures to reduce tax avoidance). They did not announce their position regarding a sale of the student loan book, though Liam Byrne, Shadow Minister with responsibility for higher education until the election, had previously backed a sale.¹⁴

Although Ministers have invoked the increase in tax revenues from having more graduates, the accounting is such as to preclude the same argument being used to justify increased funding from general taxation. Greg Clark, the former Minister for Universities, Science & Cities, told the House of Commons in January 2015:

*Let me say why the system is good for taxpayers, as the OECD director said. The reforms have made it possible—without them it would not have been possible—to abolish the cap on student numbers. That is overwhelmingly in our national interests, as I think most Members would acknowledge. The earning power of graduates means that it is not just the graduates themselves who gain—the Exchequer gains hundreds of thousands of pounds over a graduate's lifetime of employment. That is many times more than even the most conservative estimate of the so-called RAB charge.*¹⁵

Increases in future tax revenues are not hypothecated to the department responsible for higher education and are not scored in a way to count against present expenditure. The grant funding of education might be a human capital investment, but it does not create a clearly defined asset like a loan so it still appears in the accounting as current expenditure. Human capital investment in itself is insufficiently formalised to score in the accounts or headline statistics that dominate the thinking of our politicians and civil servants.

Too much higher education commentary focuses on the deficit, when loan action is elsewhere: cash flows and their impact on public debt. It is important to keep this in mind as the switch to the departmental level in the next chapter brings a focus on annual budgets and asset valuations which look quite different.

Chapter 3

Student loans and departmental accounts

The BIS Department has responsibility for English higher education. It funds English-domiciled students wherever they study in the UK, through grants and loans, and provides tuition fee loans to EU citizens studying at English higher education institutions. Student loans appear in BIS's departmental accounts as assets because they are money owed to government.¹⁶

At major fiscal decisions, such as spending reviews, departments are allocated budgets known as Departmental Expenditure Limits (DEL). As part of this process, BIS is allocated a special element to cover the anticipated losses on the student loans issued each year. Unlike much other BIS spending, this part of the allocation is ring-fenced so it may not be reassigned to other purposes without Treasury permission.

This allocation is used to create an impairment provision in the departmental accounts, which reflects the fact that the loan assets are worth less to government than the sums loaned out to students in the first place. But this is not a provision in the sense that cash is set aside for future use (it is not a rainy-day fund). Instead, it is 'non-cash': a simple recognition today that the value of repayments over the lifetime of the loans will be lower than the value of the borrowing (and related costs) used to create them. This is a private-sector approach to valuing assets, with the

impairment recognised as soon as it is assessed. The private sector though does not usually create loans that are intended to make a loss.

The impairment has two elements:

An interest-rate subsidy to reflect the fact that the government makes annual payments against the borrowing used to create loans and that these payments are lower than the interest payments receivable from graduates.

A write-off subsidy to reflect the remaining estimated difference between the principal borrowed by government via gilts and the repayments received. Although it is recognised in the departmental accounts when the loans are created, it is only utilised at the end of the lifespan of the loans.

These two elements together comprise the Resource Accounting and Budgeting charge or RAB charge. It is resource allocated and used to cover impairment in value.

Departmental accounts are run on an accruals basis, so events must be recorded when a commitment is made, not when the relevant transactions occur. In this respect, departmental accounts differ from the national account cash flows examined in previous chapters as the estimated loss is calculated in advance and recorded in the books upfront.

In the House of Commons in early January 2015, David Willetts, the former Minister for Universities and Science, said: 'The RAB charge is not real money that is actually being spent and that can be diverted to another purpose.'¹⁷ But the RAB is

nonetheless a way to represent the real cash lent to borrowers and the real cash that will be returned in future years. No one can reasonably expect the Treasury to allow £10 billion to be paid out in tuition and maintenance loans each year without some measure of how much may come back.

The RAB charge is usually expressed as a percentage of non-repayment (currently around 45 per cent) but in budgets and accounts it is allocated and recorded as a sum. So the key question on sustainability: is has BIS been allocated enough resource to cover the impairments needed for new loans and any changes to the valuation of pre-existing loans? A loss-making student loan scheme is sustainable if resource is found elsewhere to sustain it. Student loans are not generally meant to be self-financing, even though the Coalition said they wanted the proposed new postgraduate loans to pay for themselves: 'Individuals will, on average, repay in full'.¹⁸

Spending allocations are typically determined years in advance. So the 2010 Comprehensive Spending Review set BIS's budget and RAB allocation until the end of 2014/15. In contrast, estimates about loan repayments are so volatile and uncertain that they are updated every six months in response to new economic data.

When downward revaluations of existing loans occur, a stock charge is required. As with the RAB charge, this needs funding because it is an additional impairment on the loans. So it is normally scored in the same special ring-fenced component of DEL at the time when the change in value is first recognised.

BIS Financial Statements

The BIS annual financial statements track impairments as they accumulate and are unwound. They convert the face value of BIS's asset into a fair value based on estimated future repayments. At the end of March 2014, the face value of outstanding student loans was £54 billion but the fair value (the net present value of future repayments) was estimated at £33.3 billion.

The table below summarises all the changes of existing student loans for 2012/13 and 2013/14. There are separate adjustments for: repayments from former students; disposals (the sale of the remaining pre-1998 mortgage-style loans); 'amortisation', which covers the annual interest subsidy plus the continuing impact of low bank base rates on pre-2012 loans; interest accrued on borrowers' loan accounts; and impairments for both new and existing loans.

Changes to English student loan assets

	£ billion	
	2012-13	2013-14
Student loan assets		
Opening balance	28.1	30.7
Closing balance	30.7	33.3
Change	2.6	2.6
of which:		
New loans issued	7.1	9.0
Repayments	-1.6	-1.5
Disposals	0.0	-0.1
Amortisation	-1.5	-1.9
Interest	1.0	1.3
Impairments	-2.4	-4.2

OBR, *Fiscal Sustainability Report*, 2014, p.173.

In 2012/13, although £7.1 billion of new loans were issued against £1.5 billion of repayments, the value of loans held only increased by £2.6 billion. When added together, amortisation and impairments come to nearly £4 billion. In 2013/14, £9 billion of loans were issued but again only £2.6 billion was added to the fair value of the loan book. Half of the £4.2 billion impairments in 2013/14 were for impairments on new loans issued (RAB charges) and half were changes in the value of pre-existing loans (the stock charge).

A significant part of the increase in the stock charge was caused by changes to the modelling of repayments in late 2013, when the RAB charge on new loans was revised upwards from 35 per cent to 45 per cent.¹⁹ But it is not the level of the RAB charge that is the issue; it is the relative standing of the allocation and the impairment. RAB is an issue because of the excess of the latter over the former. The higher level of RAB impairment was not budgeted for.

The discount rate

The value of the student loans is determined by the relation between repayments generated by the loan accounts and the borrowing the government uses to create them in the first place. So what is the government's cost of borrowing?

This is a surprisingly complicated question. The government does not match a specific bond issuance to specific loan accounts or a specific year's loan issuance. No effort is made to construct a specific calculation of the costs of borrowing for specific student loans. There is instead a single discount

rate, which is applied to future cash receipts to determine how much they are worth today, for all financial reporting and budgeting of long-term assets.

The government uses a discount rate that represents the risk-free, long-term effects of the government's borrowing liabilities. This long-term rate is set by the Treasury in consultation with the Financial Reporting Advisory Board (FRAB). FRAB minutes from December 2013 confirm the methodology used to set the discount rate, which is currently 2.2 per cent above inflation as measured by the Retail Prices Index.²⁰ It is this rate which is applied to estimated loan repayments.²¹ When BIS values the loans it issues and holds, it reaches the fair-value position by discounting estimated future payments by that rate for each year they are away from the present.²²

However, the discount rate is a long way above the government's true current cost of borrowing and has been fixed at 2.2 per cent above inflation since 2005/06.²³ No change has been made despite interest rates being at historic lows since 2009.

This has led some people to argue that the figures cited for the loss on loans, and therefore the RAB charge, are overstated. If so, the loans are undervalued as assets and BIS's overall position does not represent the loss on loans to government.

In a submission to the BIS Select Committee, Professor Neil Shephard of Harvard University stressed the gap between the actual costs of borrowing and the discount rate:

During the recent recession these interest rates were roughly 3%, nominal. If we assume the Bank of England

maintains inflation at the announced target of 2%, this is around 1% nominal. Although 2.2% - 1% real does not sound much, when you compound it over 30 years it makes a vast difference. It accounts for around 1/3 to 1/2, of the so-called losses on the student loans. The Treasury is overcharging BIS. Put another way, the actual cost to the country of student finance is far lower than reported.²⁴

A similar point is made by the OBR:

Estimates for the RAB charge use RPI plus 2.2 per cent as a proxy for the interest on government debt, and are very sensitive to this assumption; a 1 percentage point reduction in the discount rate would reduce estimates of the RAB charge by something of the order of 10 percentage points. No specific gilts are issued to finance student loans – the Debt Management Office (DMO) finances the total net cash requirement in accordance with the Government's debt management policy objective – but the Exchequer is currently servicing its debt at lower rates of interest than RPI plus 2.2 per cent on average.²⁵

The former Minister for Universities and Science, David Willetts, told Parliament in January 2015:

One piece of advice I would give to my excellent successor [Greg Clark] is that he should go back to Treasury and ask why we are all having an argument about a figure that is based on a completely incorrect assumption for the cost of Government borrowing. If he does not do it, and the right hon. Gentleman were to be in Government [Liam Byrne], I will make a modest

prediction that one of the first things that will happen to the RAB charge is that there will be a different and more realistic cost of Government borrowing, and lo and behold, the RAB charge will suddenly be discovered not to be 45%. As the OBR helpfully point out, 1% off the cost of Government borrowing lowers the RAB charge by 10 percentage points. So we are stuck on a calculation, one crucial element of which is fixed by Treasury stipulation. It does not respond to the real world.²⁶

What is missing from this story is that BIS made this request to the Treasury in 2012/13 and was rebuffed. The discount rates were reviewed in November 2013 and the current level was retained. This may have been because the Treasury and the FRAB expected the cost of borrowing to rise shortly (the OBR estimates the yield on gilts will rise to 5 per cent by 2020 when RPI could be 3.3 per cent). FRAB minutes from December 2013 indicate that 'the introduction of the new long-term rate has been delayed until the next Spending Review'.²⁷ It may be that the rate is scheduled to come down and this underlies Willetts's 'modest prediction'.

But there is an important aspect which is missed by this tale of overcharging. The discount rate is primarily about budgetary control and stability. It is not simply acting as a proxy for the current cost of borrowing. In the commercial sector, it is common to see each project assigned a separate discount rate determined in part by, for example, the cost of borrowing available at the time. But government needs a uniform long-term discount rate to maintain a stable policy-making environment. The current rate is a compromise that meets the standards of the accounting

community and provides the requisite planning environment.

Yet, while that justifies a single rate, it does not explain why the current rate has not been revised for a decade. The Treasury stresses that the discount rate is not like the other inputs into the student loan calculations – it is a budgeting parameter. So we need to return to consider the RAB charge as an allocation that is then used to create an impairment.

Were earnings growth to improve or student loan repayments to be increased by changing the terms of the loans, the estimated losses would fall against the RAB allocation. The impairment would go down but the allocation would remain the same. However, were the discount rate for financial reporting and budgeting to be revised, then so too would the allocated RAB provision. The value of the loans would increase with a lower discount rate, but the RAB charge allocation would be reduced accordingly (and *vice versa*).

The 2014/15 *Consolidated Budgeting Guidance* on student loans shows that such a change is merely a change in classification:

*In all cases any adjustments to the impairment arising from a change to the discount rate will be treated as a change of accounting policy and in budgets treated as a classification change.*²⁸

Since there would be no change in activity being resourced, the budget allocation for RAB would be 'restated' so as not to 'create spending headroom'.²⁹ If we return to the example cited above – in which a 1 per cent reduction in the cost of government borrowing reduces the RAB charge by 10

percentage points – then we should expect the RAB allocation to be revised downwards by a similar amount.

This confirms that the RAB charge, although based on the same underlying estimates of repayment, does not actually express the government's loss on loans but reflects departmental budgeting and accounting treatment that has been brought into line with private-sector practice.

A lower discount rate would make headlines about the loss on loans look less drastic and probably change the discourse around sustainability, but for the department in charge of higher education spending there would still be the same set of challenges for the student loan book. For example, fluctuations in estimated repayments would still occur.

Nonetheless, the discount rate plays a different role in any sale of student loans. If the RAB charge figure does not represent the actual loss to government, owing to the financial reporting discount rate being higher than the true cost of borrowing, then a sale is a worse proposition. Indeed, it is clear that any sale of student loans will precipitate heavier than anticipated losses today, since the central 'Value for Money test' would be derived from the higher 'social time preference discount rate' (inflation plus 3.5 per cent) rather than the financial reporting one of inflation plus 2.2 per cent.³⁰

This suggests the Treasury's over-riding concern is to change the cash-flow timings and to reduce PSND more quickly than would occur through waiting for student loan repayments to climb to significant levels.³¹

Chapter 4

Student loans and sustainability

When the current policy for undergraduate funding was agreed in 2010/11, the estimate of BIS's discounted losses on each year's loan issue – the RAB charge – was put at between 28 per cent and 30 per cent of the initial face value. Under pressure from HEPI and others, this figure crept up as data about the graduate labour market appeared and optimism about the economic recovery receded. By the Autumn Statement of December 2013, the official estimated loss was 35 per cent. Three months later, it was 45 per cent.³²

If you issue £10 billion of loans, a change of 10 percentage points is equivalent to £1 billion being wiped off the value of the loans. In 2015, BIS expects to get back the equivalent of £5.5 billion rather than the approximately £7 billion it envisaged in 2010/11 because the RAB charge has hit 45 per cent.

In 2010, the Comprehensive Spending Review put the budget for the RAB charge at £2.9 billion for 2014/15. When the 2013 spending round set the allocation for 2015/16, it had grown to £4.4 billion. Both these amounts predated the downwards revisions to estimated repayments in late 2013/14. At least £10 billion of loans will be issued in 2014/15, meaning a RAB of £4.5 billion, and close to £12 billion will go out in 2015/16, meaning roughly £5.4 billion is required. That leaves an excess

of impairments over allocations of £1.6 billion and £1 billion respectively for those two years.

The whole loss on each year's loan issuance is to be covered by that year's RAB charge. This convention dates from 2010/11 and was part of the Clear Line of Sight project that reworked budgeting and accounting presentation and conventions. Beforehand, the estimated loss on each year's loans was covered on a pro-rata basis over the loans' lifetimes – so that for a thirty-year loan, one-thirtieth of the estimated loss would be covered each year. That earlier convention was still in place at the time of the Browne Review of 2009/10 and the RAB charge is often discussed as if nothing has changed. For those living in 2010, the RAB charge is a non-issue. David Willetts told the House of Commons in January 2015 that the Treasury allows 'the accounting charges to happen at a rate of one thirtieth a year.'³³ That was indeed what happened in 2009/10, but it has not been the case since.

If a department needs more resource than allocated in a particular year, it can request a supplement from the Treasury. Supplementary Estimates, which are published each year, show the approved additional resource that a department can access before the end of the financial year in March. This data provide a sense of the scale of the challenge represented by student loans and how close questions of sustainability came to the fore in 2013/14, as estimates of loan repayment began to decline and diverge from the RAB allocation.

Before 2013/14, the supplementary estimates only related to the ring-fenced provision in Departmental Expenditure Limits (DEL) — the first columns. From 2013/14, an additional facility became available in Annually Managed Expenditure (AME) to deal with the volatility of the new loans issued to those starting undergraduate study since 2012.³⁴

Additional budgetary resource required to deal with student loans (£ billion)

	DEL Reserve claim	DEL Used	AME Reserve claim	AME Used
2011/12	2.9	2.2		
2012/13	1.8	1.5		
2013/14	5.5	2.6	1.2	0.8
2014/15	2.1	Not available	2.0	Not available
TOTAL		6.3		0.8

Rounded to nearest £0.1 billion

The table above shows the reserve claims approved for additional excess impairments to student loans, new and existing, and how much of that resource was actually used. That is, these are in addition to the original spending round allocations for the RAB charge. Data on resource utilised is not yet available for 2014/15.

A combination of factors has been at work, including: lower than expected graduate salaries; low bank base rates; and higher than anticipated loan take-up.³⁵ However, a major

contributor to the revisions in the value of the loans was the new repayment forecasting model. When key assumptions were replaced by more realistic ones, the impact was stark.

The 2013/14 BIS financial statement explains:

The accuracy of modelling has improved through better use of historical repayment and earnings data. The RAB charge for post-2012 HE reform loans is now estimated to be around 45%. Total impairments of new and existing loans in 2013-14 were £6,141 million (2012-13 £3,919 million). Impairments on pre-2012 HE reform loans, including the costs of the cap on interest rates operating for a further period, were £3,165 million (2012-13: £3,183 million).

When setting budgets, the Department must anticipate the outcome of the forecasts and modelling changes and agree cover with HM Treasury to ensure the required Parliamentary approval is in place for a range of eventual scenarios. In 2013-14, the Department received £6.7 billion from HM Treasury in DEL non-cash and AME budgets to cover the impact of the changes above, of which £3.4 billion was utilised...³⁶

Note that the total impairment of £6.1 billion was split between post-2012 loans and pre-2012 loans (some of which had already been issued) and was met by £3.4 billion of supplements on top of the original spending-round allocation for 2013/14. This total £6.1 billion non-cash impairment goes in the books to reflect the fact that the value of loans issued is

less than the borrowing used to create them and that the value of already existing loans has deteriorated. But what is to stop the Treasury from going on providing BIS with more non-cash whenever the estimates shift? The answer to this conundrum is that the Treasury wants control of the long-run financial position. In particular, it is concerned about associated cashflows. If the value of the loans falls, that means that a lower level of repayments is expected and that will affect the path of national debt over time. So the Treasury is less concerned about the status of the RAB charge and more concerned about the cash flows and their timings that the RAB reflects. It transpires that 2014 was a turning point. A line was drawn.

In late 2013, *the Guardian* reported that BIS was facing a 'major fiscal challenge' and had been instructed to identify emergency savings of £400 million in 2014/15 and £800-900 million by 2015/16.³⁷ But this scenario did not materialise for the simple reason that the accounting rules were changed in April 2014 retrospectively to cover the financial year 2013/14.³⁸ The Treasury recognised that the volatile factors affecting loan repayments, such as low bank base rates and the recession, were not within BIS's direct control.

A new approach was adopted but it did not let BIS entirely off the hook. It was designed to give BIS a means to manage shocks relating to post-2012 loans via a new facility within Annually Managed Expenditure – the second column in the table above – in addition to the ring-fenced provision in DEL. This new facility must be serviced by making reductions to planned spending elsewhere or obtaining extra resource at

major fiscal events, such as a spending review. Excessive RAB charges do not translate into reductions in expenditure elsewhere. The RAB charge is not only non-cash anymore; it affects other spending directly.

A technical paragraph in the 2014-15 *Consolidated Budgeting Guidance* produced by the Treasury explains:

Any revaluation of the impairment that occur[s] periodically because the original values were based on forecasts that have turned out to be incorrect, or because of updates made to the student loans model, and which go beyond the target impairment set by the Treasury, will be charged to DEL over a 30 year period (unless departments decide to cover the costs from their DEL over a shorter timeframe). One thirtieth of the total cost will be charged to non ring-fenced RDEL [resource DEL] each year for 30 years, with the residual amount each year RAME [resource AME]. The net effect of these entries in RDEL and RAME each year will equal the annual impairment charge due to these forecast changes...³⁹

Note that the Treasury sets a target impairment for post-2012 loans as they are issued. This is currently 36 per cent, which was the estimated RAB charge at the time of the 2013 spending round. If the RAB charge should be above that level for new loans, as a result of variations in the forecasting of repayments, then the new procedure kicks in.⁴⁰ Note also that the excess RAB charge – the nine percentage points separating 45 per cent from 36 per cent – is moved into the AME budget.

In 2013/14, BIS used £800 million of this facility. For that year and the following twenty-nine years, one thirtieth of the excess (£26 million) is charged back to BIS, which must find the resources to cover the charge by making cuts to its other planned spending in non-ring-fenced DEL.

For 2014/15, BIS has permission to utilise £2.0 billion of AME. Were it to utilise that in full, the AME facility would increase to nearly £2.8 billion and one-thirtieth of that, from now on, roughly £90 million, would need to be cut from planned spending in subsequent years.

This extra facility gives BIS breathing space by smoothing short-term problems over the lifetime of the relevant loans. But it does not solve the fundamental problem of diminishing estimates of repayments. If the required impairment for 2015/16 is materially above target, then BIS has to find further savings, and so on. The growing impact on BIS's budget would become significant. There is as yet no fixed estimate as to when the arrangement might reach the limit of its usefulness. It is unlikely that the RAB impairment could continue to run at its current rate over an entire five-year Parliament, though there has been no explicit discussion of a tipping point. This though is a very different matter to current debates about financial 'black holes' two or three decades away. A lower discount rate would reduce the spread between the target impairment and the current RAB charge, which would then translate into a smaller spillover into other expenditure reductions.

The estimated non-repayment on new loans issued may improve as the economy performs better, although significant increases in the value of existing loans are unlikely without any changes to the repayment terms. Forecasts on existing loans already factor in a return to higher earnings growth after 2020. Their values are impeded by current conditions.

This new risk-sharing agreement between BIS and the Treasury should have fundamentally altered discussions on the sustainability of the student loan scheme. While it recognises changes in the economy may not be within BIS's direct control, it still ensures they get a response. But, if BIS's annual spending is hit significantly, it will force new policy options to be considered.

Options

A reconsideration of the terms and conditions of student loans is likely. For example, the maximum tuition fee could continue to be frozen at £9,000 as it has been since it was introduced in 2012. Or the interest rate, repayment rate, repayment threshold and write-off period could be amended. Such changes can be made without new primary legislation.

The clearest candidate is freezing the repayment threshold, which the Coalition committed to increase in line with earnings after 2016. Unlike changing the interest rate or amending the write-off period, this would make an immediate difference to repayment levels and would be justified on the grounds that the £21,000 threshold is higher compared to average earnings than originally anticipated due

to sluggish earnings growth.⁴¹ Such changes could be applied to new borrowers but are also permitted for already existing loan accounts, and running a single threshold would be preferable for HM Revenue and Customs and employers in terms of payroll functions.

Such 'tweaking' could even become the fundamental means of securing the budgetary sustainability of the undergraduate finance regime. According to Matthew Hilton, a former senior BIS civil servant:

*the government could reduce the RAB charge to whatever it wanted at a stroke, and within the existing overall policy framework, just by adopting a different approach to the financial management of the student loan book. If interest rates, repayment levels etc. were able to flex in line with the macro-economic context, the RAB issue would go away.*⁴²

In sum, the Treasury appears to have imposed a settlement which requires BIS to improve repayment rates or risk seeing its other spending cut year-on-year. The accounting is pushing policymakers towards certain solutions, which may not be in the general interest of universities and colleges or students. At the very least, they need proper debate because higher education needs public goodwill, not just public money.

While policymakers might come to argue student loan repayment terms can be altered just as easily as income tax rates, others already argue that changing the repayments terms of a contractual loan for existing borrowers is morally indefensible.⁴³

Conclusion

The accounting and budgeting treatment of student loans at both departmental and national levels is complex. But it is impossible to understand student loan policymaking fully without some understanding of how the loans appear in the accounts.

Loans need good accounting conventions to deal with their volatility, but headline statistics and accounting conventions should not be mistaken for natural phenomena. They reflect accumulated decisions and revisions that could be distorting higher education policy.

With regard to national accounting, we need to be aware always of how student loans figure – or are absent – in the headline statistics for public sector finances. It makes student loan sales look good in the short-term even if they represent a long-run loss.

At the departmental level the RAB charge is forcing policymakers in BIS to consider spending cuts or responding with tweaks to the loan repayment terms. A 'major fiscal crisis' for BIS was averted by changing the conventions, but we need to understand how projected loan non-repayment motivated those changes and how it impacts now on BIS's budget in new ways. The budgeting treatment of student loans may have to be reviewed yet again if altering the loan terms for existing borrowers risks a loss of public confidence in higher education.

In these cases, we need to be assured that unexamined conventions are not driving higher education policy. We need to understand accounting and budgeting conventions as choices, so as to better assess what the conventions are meant to achieve. If we are unthinkingly making policy to fit the accounting, then something has gone awry with our political and policy thinking.

Notes and references

- ¹ From £4.5 billion in 2009/10 to just over £1 billion in 2015/16.
- ² Office for Budget Responsibility (OBR), *Fiscal Sustainability Report*, July 2014, p.178.
- ³ Andrew McGettigan, 'Cash Today', *London Review of Books*, 5 March 2015.
- ⁴ Department for Business, Innovation and Skills (BIS), *Annual Report and Accounts 2012-13*, 2013, p.102.
- ⁵ Voluntary repayments may also be made.
- ⁶ For a discussion of the change to loan accounting, see The National Committee of Inquiry into Higher Education, *Higher Education in the learning society*, 1997, pp.326-327.
- ⁷ If the government receives a fair price for the loans, it will have swapped cash today for an equivalent stream of future payments. In the long run, repayment receipts have been sold to a private investor. In the short term, the sale proceeds can be used to reduce debt or fund other activities.
- ⁸ OBR, *Fiscal Sustainability Report*, 2014, Table 3.11 shows PSND at 54 per cent of GDP in 2033/34.
- ⁹ Personal communication, 7 July 2014.
- ¹⁰ Nicholas Macpherson, 'The Treasury View: a Testament of Experience', 15 January 2014 (<https://www.gov.uk/government/speeches/speech-by-the-permanent-secretary-to-the-treasury-the-treasury-view-a-testament-of-experience>).
- ¹¹ The OBR notes that debt has increased by 150 per cent since the crash but the low level of interest rates means that interest payments have only increased by 75 per cent.
- ¹² For more detail, see Andrew McGettigan, 'Cash Today', *London Review of Books*, 5 March 2015.
- ¹³ '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).' BIS, *Higher Education: Students at the Heart of the System*, 2011, §1.41.
- ¹⁴ John Morgan, 'Academy's fat cats "too smart" to attack Labour's £6,000 fees policy', *Times Higher Education*, 16 October 2014.
- ¹⁵ Hansard, 8 January 2015, col. 446.
- ¹⁶ This chapter offers a simplified overview of departmental budgeting and accounting for loans. For more detail, see HMT, *Consolidated budgeting guidance 2015 to 2016*, 2015.
- ¹⁷ David Willetts, '£6k tuition fees will not work', *Times Higher Education*, 18 September 2014.
- ¹⁸ BIS, *Consultation on Support for Postgraduate Study*, March 2015, p.14.
- ¹⁹ OBR, *Fiscal Sustainability Report 2014* §B19.

- ²⁰ Financial Reporting Advisory Board (FRAB), 'Update on discount rates set at 30 November 2013', FRAB 119/06, 13 December 2013.
- ²¹ 'Student loans are held at amortised cost. This involves the gross value of the loans issued being discounted to net present value using the effective interest rate. The effective interest rate for student loans is RPI plus 2.2%, which is the Treasury discount rate. The Treasury has directed the Core Department to use this rate for student loans as this is the Government's long term cost of borrowing.' BIS, *Annual Report and Accounts 2011-12*, 2012, p.166.
- ²² A payment received in five years time would be discounted by dividing the estimated cash amount by $((1+RPI/100)*(1.022))^5$ five times.
- ²³ Before that, the rate was lowered to 3.5% from 6% above RPI in 2003. So there were two reductions in the space of three years.
- ²⁴ Written evidence submitted by Neil Shephard to the BIS Select Committee (<http://data.parliament.uk/WrittenEvidence/CommitteeEvidence.svc/EvidenceDocument/Business,%20Innovation%20and%20Skills/Student%20Loans/written/4849.html>).
- ²⁵ OBR, *Fiscal Sustainability Report*, 2014, SB17.
- ²⁶ Hansard, 8 January 2015, col. 428.
- ²⁷ Financial Reporting Advisory Board (FRAB), 'Update on discount rates set at 30 November 2013', FRAB 119/06, 13 December 2013, §4.
- ²⁸ HMT, *Consolidated Budgeting Guidance 2014 to 2015*, 2014, §8.20.
- ²⁹ HMT, *Consolidated Budgeting Guidance 2014 to 2015*, 2014, §1.43.
- ³⁰ The specific discount rate used for the 'value for money' test begins with the rate of RPI plus 3.5 per cent. One percentage point is subtracted to remove the 'catastrophe risk' factor built in to this rate. A market-based risk premium is then added back in to reflect the 'endogenous risk costs' of student loans. HM Treasury, *Value for Money and the valuation of public sector assets*, July 2008.
- ³¹ For more detail, see Andrew McGettigan, 'Cash Today', *London Review of Books*, 5 March 2015.
- ³² Rumours in higher education suggest that were the discounted estimate of non-repayment to pass 50 per cent then student loans would be reclassified as normal expenditure rather than 'policy lending'. I have confirmed with the Office for National Statistics that this is not the case.
- ³³ Hansard, 8 January 2015, col. 427.
- ³⁴ AME is used to manage spending on volatile items and is not within departmental control (other examples are welfare and pensions). There are no allocations, the facility is designed to absorb excess unplanned resource in demand-led budgets.

- ³⁵ In previous years, BIS estimated that £1.5 billion of in-year impairments could be attributed to low bank base rates, which resulted in interest on pre-2012 loan balances accruing at less than RPI. That impairment is now included under 'amortisation' and the issue does not affect post-2012 loans.
- ³⁶ BIS, *2013-14 Annual report and accounts*, p. 88.
- ³⁷ Andrew McGettigan, 'BIS blew its budget, and now the entire higher education sector will have to pay', *Guardian*, 22 November 2013 (<http://www.theguardian.com/commentisfree/2013/nov/22/bis-budget-higher-education-sector-cuts>).
- ³⁸ <http://andrewmcgettigan.org/2014/03/23/changes-in-201415-for-the-budgeting-of-student-loans/>
- ³⁹ HM Treasury, *Consolidated Budgeting Guidance*, 2014-15, S8.19.
- ⁴⁰ Note that the revisions to the RAB charge needed must be related to changes in forecasting. If, for example, higher levels of loans are issued than expected then BIS would need a separate negotiation over the provision of additional resource through the DEL provision.
- ⁴¹ Another option would be to consider the creditworthiness of individuals and institutions using performance data on repayments.
- ⁴² Matthew Hilton, 'Politicians: please don't screw it up', *wonkhe*, 16 January 2015 (<http://wonkhe.com/blogs/politicians-please-dont-screw-it-up/>).
- ⁴³ Martin Lewis, 'A deliberate threat to govt', *moneysavingexpert.com*, 9 January 2015 (<http://blog.moneysavingexpert.com/2015/01/09/a-deliberate-threat-to-the-government-u-turn-on-the-21000-student-loan-repayment-threshold-i-will-organise-mass-protest/>).

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Understanding of how student loans appear in the national and departmental accounts is poor. Yet the issue is crucial to the future of student finance, to any sale of the student loan book and even to the size of the UK's debt. This paper seeks to explain the accounting and budgeting of student loans in the interests of better policymaking.



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