Research Fortnight

The Third Revolution

Part four of a major series investigating how new forms of capital and constitution are set to reshape higher education in England

Shifting the risk

4. loans: reducing risk

by Andrew McGettigan am@ResearchResearch.com
Series editor: William Cullerne Bown

If future governments stick to the course mapped out by the coalition, then by 2046 the government will be owed almost £200 billion in student loans. The generous support promised to low-earning graduates means that the plan is for the government to write off about 30p in every pound lent. But whether the losses for the Treasury will turn out to be 30 per cent or 40–50 per cent cannot be known for decades.

So in the recent White Paper on higher education, *Students at the Heart of the System*, the government made reducing the risk of excess losses on student loans its main policy objective. In turn, the steps taken to contain the risk are capable of shaping the entire system of higher education in England.

For example, the new system can measure non-repayment rates at individual institutions, and even for individual courses. This could enable the government to reduce the risk of graduates failing to repay their loans by persuading universities to either set lower fees or offer the types of courses that have high repayment rates. The heavy hand of the market could come into the heart of universities, at a considerable cost to their traditional autonomy.

The government has four, not-mutually-exclusive options to consider to reduce risk on the student loan book.

Introduce private loans

Option one, the most direct way of shifting the risk, would be for the government to avoid lending to students in the first place. And earlier in the year, David Willetts was reported to be in discussions with the Spanish banking group Santander regarding the possibility of independent loan schemes. Steve Smith, then president of Universities UK, indicated that banks were keen to be involved —but only if the risk of non-repayment was taken by someone else. [1]

However, the accounting conventions set by the International Monetary Fund and the World Bank create a significant barrier to this. Under these rules a guarantee of this sort for all the UK's student loans would leave the liability for non-repayment on the government's books even though the loans themselves are now owned by a private bank. (*For more detail, see the Nick Barr interview, page 2*).

So although the loan might move, the risk wouldn't. Perhaps not surprisingly, the discussions between Willetts and Santander seem to have led nowhere.

Make students pay

Once a student leaves university, there are two main factors that determine how much they pay back on their loan and hence how much the government eventually has to write off. These are the salary of the graduate (or non-graduate if they don't complete their course), which is out of the government's control, and the regime of interest rates and repayment thresholds in the loan scheme itself, which is surprisingly open to manipulation by future governments.

The contract that students sign to take out a student loan is a curious beast. In stark contrast to the concrete-sounding promises in ministerial speeches, it specifies no interest rates or repayment thresholds.

Page 7 of the 2010-11 contract states: "You must agree to repay your loan in line with the regulations that apply at the time the repayments are due and as they are amended. The regulations may be replaced by later regulations." [2]

So the loans are not just income-contingent but future-policy-contingent too. Which brings us to

This is the second instalment of a three-part article, part one was published with *Research Fortnight* on 16/11/11, part 3 on monetisation will follow.

interview nick barr

On the impossibility of replacing government student loans with loans from private lenders

Nick Barr is a professor at the London School of Economics. He is an eminent theorist of income-contingent repayment loans and in the 1990s helped Hungary's government set up its loan scheme, which is entirely funded through the private purchase of bonds linked to graduate repayments. The scheme has been running for more than 10 years and has a RAB charge of less than 5 per cent.

Barr is critical of the loan scheme now confronting the UK, and of the educational aims of the recent higher education White Paper. Of the latter, he told a select committee on higher education: "It is not clear how a structure designed to reduce price will lead to improved student experience."

How far do you think it is desirable or feasible for individual institutions or small groups of institutions to set up their own loan scheme to avoid some of the problems that surround the government's proposals?

The problem with independent loans goes right back to Milton Friedman, who first wrote about this in 1955. Question: why do we have private home loans but not private student loans? Answer: there is no physical collateral for investment in human capital and that is, in principle, true for any independent loan system.

The only exception is if you are lending to a class of people who cannot disappear. Doctors and lawyers, for example, have to be on a professional register if they are to practise. If you lend me money to finance my medical training, then I cannot run away and hide. There is no physical collateral: the collateral is my career.

What about the Prodigy scheme that finances loans for people studying at France's leading graduate business school, Insead?

It's the same as for lawyers and doctors. If you are a graduate of Insead, you are a member of a small, global network. It is very hard to disappear. Naming and shaming works. It achieves, through a professional network, what legal bits of paper achieve for doctors and lawyers.

But is it not feasible for undergraduate degrees at universities in the UK's Russell group?

No. An independent loan scheme is in practical terms a niche model, it won't generalise.

What about the recent discussions between Spanish bank Santander and David Willetts about setting up independent loan schemes? Santander indicated that they would consider financing students at Russell group universities.

I'll tell you exactly what's going on. Banks love the idea of lending money to students with a government guarantee. Banks make profits. They don't want to face risks if the government can take the risk. That, I imagine, is the model that Santander had in mind, just as the banks did in 1989 when the then education secretary Kenneth Baker was first trying to set up a loan scheme.

The problem is that if students borrow money from banks, but government guarantees the loans, the Office for National Statistics will classify it as public money, not private. But the purpose of any sale for the government is to bring in private money.

There is a government guarantee in Hungary, which Eurostat is prepared to treat as private. But when the Browne review looked at the Hungarian specifics, their view was that the UK's ONS, which is hard-line on these things, would class it as public expenditure.

If you want private finance for a loan with no physical collateral, and only a small government guarantee, then you are threading the eye of a needle, and that requires technical expertise and a situation where the politicians don't tinker. If that happens, I'd be delighted, but I'm not about to bet the family farm on it.

Nick Barr was interviewed by Andrew McGettigan on Wednesday 3 August 2011

option two—charging the students more. When tuition was cheap, this mattered less to students. But with many students now likely to leave university £50,000 in debt and with a more expensive regime of interest rates planned, it now matters a good deal.

In practice, the government's room for manoeuvre was limited by its willingness to enact new primary legislation. The 1998 Teaching and Higher Education Act, which created income-contingent repayment loans, capped the interest rate the government could charge. [3] Rates could be set no higher than that needed to maintain the real value of the loan. This provided a degree of legislative protection for the students entering agreements. In practice, rates on current loans are administered by determining "the lower of the Retail Price Index ...or 1 per cent above the highest base rate of a nominated group of banks". This regime is cheap enough, for example, to fall outside the scope of loans regulated by the Consumer Credit Act of 1974.

The new scheme described by ministers will set interest rates that, when the graduate is earning, are higher. It will operate an interest rate taper from RPI +1 per

cent to RPI + 3 per cent, relative to earnings. To charge students the desired, higher, real rates of interest, the government had to change primary legislation. This it has just done via clauses in the 2011 Education Act that passed through Parliament this month. [4]

However, the government is going further than its already announced plans require and new legislation will allow interest to be set at market rates. The new legislation says rates must be "lower than those prevailing on the market, or no higher than those prevailing on the market, where the other terms on which such loans are provided are more favourable to borrowers than those prevailing on the market."

This amendment is at the extreme end of what is permitted by the European Consumer Credit Directive and in effect allows this and future governments leeway to alter the interest rates more easily. It becomes an administrative matter that can be dealt with by secondary legislation or statutory instruments. David Willetts previously told me, "Parliament will still have the opportunity to scrutinise the regulations and to oppose them if it feels that the Secretary of State is using his powers unreasonably."

There are two ways students could be asked to pay more, either of which could be justified by ministers in a future government pointing at the size of the government's borrowings for student loans and stating that the existing scheme had become unaffordable.

First, graduates could be required retrospectively to pay more than they are being told today. Thanks to the aggressive formulation of the new legislation, this will be capable of being implemented without primary legislation. In this way, some of the risk is already being shifted onto students.

This is not the coalition government's intention. But this government's intentions do not bind future governments, who may face more severe economic pressures to reduce debt. Who would politicians ask to pay more if the UK faced a Greek-debt scenario—graduates or NHS patients?

Students are being asked in effect to trust future ministers to keep the promises made by the current ones—something the coalition is careful to point out it has no power over.

And if you think it improbable that the UK government would retrospectively change the terms of the deal to charge graduates more, consider this: the government has recently retrospectively changed the terms on existing student loans to make them more expensive than originally promised. When RPI recently went negative for a year following the credit crunch, that negative rate of RPI was not applied to the outstanding debts on post-98 income-contingent loans.

Second, and less contentiously, future cohorts of students could be put onto a different, more expensive loan regime, enforced through reductions or freezes of the repayment threshold and increases in interest rates.

The Department of Business, Innovation and Skills has repeatedly emphasised that the figures estimating the size of outstanding loans at £191 billion in 2046 assume no future changes to student support, thereby implying there is an option to alter these terms.

So, options one and two, farming student loans out to private banks or forcing graduates to repay more than first promised might be controversial, but they are conceptually simple. The other two options the government has are far more complex. Both revolve around fine-grained assessment of the so-called resource accounting and budgeting charge [*see The Third Revolution, 16/11/11, p1*]. The RAB charge is the loss the government will make on the loans to students, currently estimated at about 30p in the pound but possibly much more.

Minimise non-repayments

The government's third option involves policing the non-repayment rates on student loans, that is the percentage of the debt that the government fails to recover.

The system of repayments to the Student Loans Company through payroll deductions gives the company access to a huge database of graduates, their earnings and their repayments. This data can, in principle, be broken down by university, and even by course, with loans for tuition fees separated from loans for maintenance. Neil Shephard, professor of economics at the University of Oxford, has been given access to the loans company data and says he plans to carry out an independent study into what can be learned from it.

Shephard's work is important because Willetts has written, "I expect that, in the future, as the data accrue, the policy debate will be about the RAB charge for individual institutions. One reason why we were not able to accept Browne's ingenious idea of a levy on higher fees is that it was indiscriminate and did not reflect the actual Exchequer risk from lending to students at specific universities." [5]

To spell out the implication: one reason that alternatives to the new regime such as general taxation or a graduate tax were rejected was because they would not enable monitoring of the RAB charge losses of individual institutions. This reflects the importance given by the government to such precise granularity.

Tim Leunig, the LSE economist and Liberal Democrat luminary, has outlined a mechanism that would use Student Loans Company data and UCAS records to construct tables matching repayments to universities, courses and "A-level or other academic attainment". [6] Thus the government could assess its likely loss "for each course, at each university, with different levels of fees".

Now we are just a step away from interpreting lower RAB charges attributable to certain students, courses or institutions as representing better "value for money" for

> 'It is important to resist the crass notion that universities are only there to generate high earnings for their graduates.'

the taxpayer. Once we get that far, then it seems entirely logical to try to minimise the RAB charge in various ways, for example by lowering fees, changing the kind of students recruited or the courses they study.

The path to this use of the historic RAB charge data on different courses could be cleared by a second potential use for the data, as a replacement for the information given to applicants by universities about employment prospects, which is currently the percentage of graduates in jobs six months after leaving. [7] The specific RAB charge for each course could be offered to applicants as an indication of their likely future earnings. RAB charges then work two ways, both to illuminate taxpayer value and the value to the individual of their potential investment. It puts a quantified value on knowledge and study, an alternative perhaps to headline fee figures.

Such measures may be complex, but the power they could exert on higher education should not be underestimated. The police-the-RAB-charge approach can be extended further, by excluding from the loans system students at universities where the RAB charge gets too high. The technical consultation document published by the government in August, proposes that the Higher Education Funding Council for England would have, "A duty to ensure not only the proper use of HEFCE's own funding but also that of publicly backed student loans as an essential part of the system to help manage overall government expenditure on higher education." [8]

A further consultation will be run over the winter to determine the exact form of control to be given to HEFCE to manage public expenditure. But the government has outlined one sanction. The technical consultation specifies, "In extreme circumstances, we think HEFCE should have the ability to suspend or remove a provider's designation for student support or HEFCE teaching grant. Providers would have an ultimate right of appeal to the Secretary of State against the suspension or removal of designation."

In other words, HEFCE would have the power to remove access to loans for students at a particular university if they are not "properly used", which could be to say, if the institution-specific RAB charge spirals out of control.

From the Treasury's point of view, the attraction of this approach is that it sets up a direct sanction that could be imposed on universities failing to control the non-repayment rates of their graduates. The threat of such a sanction may be sufficient to discipline the wayward.

Barr says, "If they went down this route, it would need to be interpreted with great care. It would be important to resist the crass notion that universities are only there to generate high earnings for their graduates and that any that fail to do so are doing a bad job. The fact that the loan repayment performance is not good is not the same thing as saying that the university is not doing a good job."

Moreover, from a technical point of view, it is not clear how the timescales involved with producing appropriate RAB data can be reconciled with present performance or how one could factor in the differing local economies in which universities are located.

For all the complexity, Willetts has made it clear that the government is interested in using university-specific RAB charges to further reform the higher education system in England. And once you get into the detail it becomes clear that schemes using this approach are intended to alter the very fabric of university planning and student recruitment.

But even this police-the-RAB-charge interference is not the end of the government's options for shifting the risk of excess losses on student loans onto others. £200bn is a huge amount of student loans to manage. If the government concludes that none of these three options can effectively contain its risk of soaring losses, then it may have to turn to a fourth—monetisation. Indeed, it is already paying enormous consultancy fees to Rothschild's for advice on how to monetise the loan book. [9]

What monetisation is, and what it could mean for England's universities, forms the third and final instalment of this article.

Next in The Third Revolution
4. loans: monetisation

References

1 http://www.guardian.co.uk/education/2011/jun/25/banks-university-funding-private-loans

2 http://www.direct.gov.uk/prod_consum_dg/groups/dg_digitalassets/@dg/@en/documents/digitalasset/dg_194538.pdf

3 http://www.legislation.gov.uk/ukpga/1998/30/section/22

4 http://services.parliament.uk/bills/2010-11/education.html

5 http://www.timeshighereducation.co.uk/story.asp?storycode=416257

6 www.centreforum.org/assets/pubs/universities-challenged-web.pdf

7 http://www.hefce.ac.uk/learning/infohe/kis.htm

8 http://discuss.bis.gov.uk/hereform/technical-consultation/

9 http://www.theyworkforyou.com/wrans/?id=2011-02-11a.39521.h

Published by Research. Copyright © Research Research Ltd 2011. All rights reserved. Reproducing Research Fortnight by photocopying, electronic or other means in any language, without the permission of the publisher is illegal.