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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

Into the shadows

4. loans: monetisation

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If it carries on with the current policy, the government is expected to be owed about £200 billion in student loans by 2046. The generous support promised to low-earning graduates means that the government expects to write off about 30 pence in every pound it lends. But if graduates earn less than expected, it could be much more than that. At the centre of the government's higher education policy therefore is a determination to find ways to minimise the risk of additional losses. [1]

If ministers conclude that conventional policy options such as introducing students to private lenders, making graduates pay more or minimising nonrepayment rates cannot effectively contain the risk of soaring losses on the new loans [all discussed in *The Third Revolution, 30/11/2011*], it has a radical alternative. Ministers could turn to a form of financial engineering known in the City as monetisation.

Monetisation is a sophisticated alternative to selling an asset, and ministers might be tempted because of the problems with an outright sale.

Seller beware

Selling the loan book in principle has attractions. It would shift the risk of any losses on the loans made exceeding 30p in the pound onto the private buyer. And it would drop into the laps of coalition ministers billions of pounds that they could spend now, without increasing the budget deficit.

And there are precedents. The student loan book has been sold before, in two tranches of £1bn. Finance for Higher Education, a subsidiary of National Westminster Bank, purchased the relatively small pre-1998 loans, which had a fixed five-year period for repayment once the graduates exceeded the earnings thresholds.

So far, so good—as long as you overlook the long-term costs of the deal. The exact terms of the NatWest sale were not made public, but some analysts have suggested that the government may have had to pay between £395 million and £405m per billion of outstanding loan debt to the "purchaser"—in other words the government probably only secured about 60p in the pound from the buyer for this asset.

The low return is why such retrospective sales, involving debt accumulated over several years, have been labelled "economically illiterate" by *Financial Times* commentator Martin Wolf—since the government always has the lowest costs of borrowing, no sensible buyer will be found unless the state is prepared to lose money in the long run. [2] In the NatWest case, it is has been estimated in a report for the House of Commons library that the subsidy offered was £85m to £100m more per billion than the ultimate cost of keeping the loans on the public books. [3]

This problem is perhaps acknowledged in the recent higher education White Paper itself, which says, "Any sale would need to reduce significantly the government's risk exposure to the loan book and represent value for money for the taxpayer." [1]

Such problems do not in themselves resolve the question of whether to sell the loan book or not. The government recently sold the Northern Rock bank despite a £400m loss on the deal. But the government has another problem: finding buyers. Governments have proved unable to sell off the income-contingent loans made after 1998 to third parties, probably because these later loans have peculiar repayment patterns that are difficult to predict. This in turn makes a book of such loans hard to value, and hence sell.

To make a sale of the new loan book more attractive, the government could raise interest rates and lower repayment thresholds, although this could be politically unpopular. Or it could sell off the loans made to students of a subset of universities with better graduate earnings profiles, but this would leave the Exchequer with an unattractive rump of loans with high nonrepayment rates, failing to reduce the risk.

In short, there appears to be no clear way to sell the new loan book outright at a sensible price. Instead, the government has started to explore complex forms

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of financial engineering to achieve the same two benefits as an outright sale—reduced risk of excess losses on the loans and cash in hand now.

Several ways of doing this have been developed in the financial world in recent decades. Our research suggests the most likely of these are covered by the term "monetisation"—the process of realising current value (cash for today's ministers) from an otherwise illiquid asset (the loans) by turning future income (graduate repayments) into present money. Buried under mountains of complexity, the issues raised by monetisation of the student loan book have remained hidden from public debate. But the impact on universities could be enormous.

Rothschild

The previous Labour government advertised for a financial adviser in April 2010 to evaluate options for the sale of the income-contingent loans portfolio. The feasibility study was immediately awarded to the Rothschild independent financial advisory group by the coalition when it came into power in May 2010 and ran in parallel with the later part of the Browne review of higher education and student finance. Ministers had already, by February 2011, paid £700,000 to cover the advice received. [4]

Section 1.42 of the White Paper reads: "The government has tasked Rothschild to lead a feasibility study to assess the options for how to monetise the loan book."

Drafts of the feasibility study report have been circulating for some months. The Department for Business, Innovation and Skills says it will not be published, but a close reading of obscure government documents has allowed us to establish both what the broad objectives of the exercise are and what progress is being made.

By examining that original procurement document alongside certain sections of the White Paper it seems that both governments were in the first place looking at some way of 'securitising' future graduate repayments. [5] This kind of monetisation involves issuing bonds, or other credit-based products, upfront to private investors. They pay for the bonds and in return receive a share of the future income stream provided by graduate repayments.

Section 1.41 we see: " We want to find a solution that will manage all current and future income-contingent repayment (ICR) loans on an ongoing basis (unlike the one-off sales of the late 1990s)." So, in contrast to the 'retrospective sale' to NatWest, the government is now seeking an 'ongoing' solution. In the procurement document, Rothschild is asked to "develop and structure a repeatable model for sale".

These phrasings—'repeatable' and 'ongoing'—point to what the financial industry terms an 'originate to distribute' model. In this approach, once each year's loans are made the government immediately sells them on to a third party, who can then slice the loans up into more marketable pieces or develop more sophisticated financial products based on the future loan repayments.

The procurement document sheds more light on this. Rothschild is to "obtain a credit rating" on the proposed structure and would "be offered the right to compete in a separate and subsequent procurement process in order to appoint institutions to find buyers for any financial instruments that may be issued as part of the sale process". What is clear from this reference is that the "sale" of the outstanding student loans would be mediated through a new kind of financial product which would require a credit rating separate to that of the UK government.

There are many financial products that can help the government achieve the monetisation goal. One of the simplest could be produced as follows. The government would sell the right to receive the loan repayments from a cohort of graduates to a new company, a special purpose vehicle. This could be the "regulated company set up to manage the loans" mentioned in the White Paper.

Its task would be distinct from the already existing Student Loans Company. The SPV would fashion a range of financial products based on the loans issued annually by the SLC and attempt to sell them to investors. The products could be defined, for example, as loans to students at certain groups of universities.

The loans, and the accompanying risk of uncertain write-offs, would be transferred from the Treasury's accounts to those of the new company. It is an off-balance-sheet solution to the problem. Risk has been transferred from the government to the SPV and then onto investors. In theory, the money raised through those 'sales' should cover the cost of issuing loans in the first place. Two problems stand out. The SPV has to get the money from somewhere to start buying tranches of the loan book. The government may be the only party willing to stump up the cash. And the government, or its proxy SPV, may struggle to find buyers for the eventual financial products.

A financial analyst with knowledge of securitisation told us, "In a normal loan book (say of credit card debt), consumer behaviour is usually quite predictable (usually because sometimes, as with sub-prime mortgages, the industry gets it totally wrong). Key data such as default rates, demographics and so on can be crunched and a loan book can be priced and sold. There are decades of data to rely on."

But with the income contingent loans of students, this predictability vanishes. The analyst explained that this makes securitisation of student loans a problem: "The more uncertainty on repayment rates and timings, the lower the price that can be achieved. Selling at a huge discount to book value looks bad and raises little." That is, it would arguably fail to represent value for money.

Echoing Wolf's complaint, the analyst says, "My current summary would be that the securitisation goose isn't going to be laying any golden eggs soon."

To sum up, securitisation reduces the government's exposure to high levels of nonrepayment by shifting the right to income from the student loan repayments to a third party. This moves the potential losses off the government's balance sheet, national statistics and out of public debate. The government would also receive some income now—helping to reduce the deficit faced by today's ministers. But the price would be potentially far lower returns in the long run—the net cost to the taxpayer could run into tens of billions. Even then, the oddness of the products means the government is likely to struggle to find buyers.

Beyond simple securitisation lie other, more complicated kinds of financial derivative, and Rothschild could be investigating those. Such sophisticated financial engineering can be seen in the government's pilot schemes for Social Impact Bonds, which are far more complex than true bonds and are now being used to finance privately-run probation services. [6]

Academia's own credit crunch

The government could turn to Credit Default Swaps, famed as the instruments that blew up many of the world's biggest financial firms during the credit crunch. A simple CDS on the student loan book would look like this. The buyer of the CDS would agree to cover any write-offs in excess of 30p in the pound. In return, the government would pay the buyer an annual fee. The risk of a large 'credit default' at the end of the loans' term has been 'swapped' for an annual fee established by a market, albeit a singular one with only one seller.

Unlike securitisation or outright sale, in this case the loans remain on the government's books but a means has been found to distribute some of the risk to private investors. The difficulty again would be finding buyers for the product at a price that makes sense to the government.

Nick Barr, an eminent theorist on income-contingent loans at the London School of Economics, says it will take time to develop the market. "I've been saying since 1998 that the government ought to have been selling off small tranches of income-contingent debt to build up a track record. At the moment markets don't know how to assess it because it is a new instrument that's not been market-tested." [*Loans: reducing risk, supplement to RF 30/11/2011, p2*]

Now the time may be right. A piloting approach for products based on student loans would allow the government to "assess the market appetite", another of the objectives given to Rothschild.

Bankers involved in the debt capital markets have told us the government needs a simple product in the early days before anything more sophisticated can succeed. So the first years may see such a conservative issue. Yet nothing need be fixed at that point. The formula can then be changed each year as the new loans are issued and more data comes in about pricing in secondary markets and, of course, new estimates on nonrepayment rates.

No concrete proposals on this front have been published, either by the government or by Rothschild. Selling debt products off the back of students may turn out to be impossible either commercially or politically. But one possibility should be highlighted because of its potentially powerful impact on academia.

The people best placed to buy CDSs are those who best understand the risk in the underlying assets. In the case of derivatives based on student loans, this would be universities themselves. Not only might universities disagree with the government's estimates about the nonrepayment rates of their graduates, they also have the ability to set fee levels and alter teaching in an effort to boost future earnings and thereby reduce the RAB, or resource accounting budget, charge for their graduates. The university could buy the CDS, take the annual fee and try to drive down the nonrepayment rates.

As with some of the methods discussed in part two of this article [*Loans: reducing risk, supplement to RF 30/11/2011*], once universities start to buy CDSs based on their own students the loop between universities, graduates and the government has been closed, creating a direct financial incentive for universities to minimise nonrepayment rates. Last year the Russell Group suggested the not dissimilar idea of crafting bespoke credit products based on the repayments of its graduates. These would be sold to alumni as an investment alternative to charitable donations. [7]

Once again, a seemingly remote mechanism being considered for managing the macrofinancing of the new student loans scheme ends up feeding back into the very fabric of university life.

In conclusion

When we enter the world of the student loan book, we enter a world of complexity and shadows that deter outsiders. Yet as this series of articles on the Third Revolution have shown, the issues around the loan book have already contributed to the decision to reject much of the Browne review. In future, the impact on universities could be even more powerful, shaping core decisions such as which courses to offer and which students to accept. For anyone who cares about the future of higher education in the UK, the need to understand and discuss the issues is urgent.

Yet inside all the complexity and financial engineering, at the core of both the decisions that have been made and the decisions that are to come, lies politics.

It might seem that the two big numbers the Treasury has to manage would cancel each other out, that the worrying extra borrowing via gilt-edged government securities needed to finance student loans would be balanced by the nice new asset being created in the SLC's loan book. But when you turn to the usual measure of the UK's borrowings, Public Sector Net Debt, it doesn't look that way. The Office for National Statistics has determined that the gilts should be included, but the loan book shouldn't.

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Antony Szary of the ONS explains. "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."

In other words, the problem is that the loan book is difficult to sell. And the consequence is that the new policy actually pushes up the national debt.

Why would a government that has staked its all on restoring government finances choose a policy that significantly inflates the figure for the national debt that appears in the *Financial Times* or on the BBC? Answer: because, as we have seen, it reduces the budget deficit. Writing recently, science minister David Willetts said, "Higher education cannot be entirely insulated from the savings necessary to reduce the deficit." [8]

"Reducing the deficit, the difference between annual expenditure and income, is important insofar as it reduces the pressure on government borrowing. Perversely, moving to a bigger loans scheme reduces the deficit *but requires more borrowing*. It is, in essence, a short-term presentational victory that benefits this government," he said.

Switching university funding from direct funding via the Higher Education Funding Council for England into loans allows the expenditure to be deferred to future years via the RAB convention. In turn, this makes the actual costs of student loans, measured in lending that ultimately has to be written off, irrelevant in the current Parliament. The twin political objectives of reducing the deficit and generous support for students have been achieved. But this has only happened at the cost of deferring the costs to a future generation, creating huge new uncertainty. The desire to minimise the risk created in turn becomes the driving force behind the development of much of the new policy in higher education. Meanwhile, this government gets a one-time-only free ride in which it does not have to account for the true cost of the nation's higher education. And as the Higher Education Policy Institute has pointed out, despite cutting billions from HEFCE's teaching budget, the new policy is as likely to end up costing the state money as saving it anything. [9]

Opposition arises to the 30 per cent estimate of the RAB charge. Ministers have sold this as a subsidy provided to lower-earning graduates. But from a different perspective, the subsidy may be viewed as a design flaw. Barr describes the scheme as 'leaky' or 'incontinent'. The scope for actual costs exceeding this estimate forces the government to strictly control student numbers and to drive down the level of tuition fees.

Further consequences can be expected as the RAB charge is framed as a quantified measure of value and so becomes more than a mere accounting convention. Active management of the RAB charge is likely to entail the 'financialisation' of higher education putting a price on degree courses through the RAB charge, whether through access to the loans or the construction of new financial derivatives.

This is arguably the main functional achievement of a fees and loan scheme: it implants new imperatives in the heart of universities. Such a new mechanism will be likely to accelerate trends of close managerial control of academics already seen within higher education and it further challenges the institutional autonomy outlined in the Robbins report in 1963. [10]

Set out as freedom from direct political interference in recruitment, staff appointments and decisions on what and how to teach, Robbins' formulation now looks old fashioned. The threat is indirect, as the new systems being devised move money differently within the system and hence alter the decisions university management makes without any direct instruction from government.

The weight of that looming £191bn of outstanding student debt can crush all opposition. Deficit reduction justifies the accounting trickery Hepi has identified, the complexity of which in turn veils a potentially profound transmutation of the universities themselves.

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