Dear Ms Hillier

The Sale of Student Loans – 69th Report of 2017-19

Thank you for your letter of 27 June 2019. Given the relevance of HMT policy within the below response, we are responding on behalf of both the DfE and HMT.

Strategy for entire loan book and modelling (Recommendations 1a, 1b and 3)

You have asked for further information on how the Government considers the student loan book in its entirety. In considering this, it is worth drawing the distinction between a) the reduction of risk that comes from each sale of any given pool of loans, and b) the risk that the loan book as a whole represents to the Government’s finances.

For each individual transaction, the strategy on reduction of risk is clear – any sale must be conducted in such a way that it results in the sold loans being removed from the Government's balance sheet as a result of their being substantially transferred upon sale. This transfer of risk has been confirmed for Sale 1 and Sale 2 by the Office of National Statistics. This objective clearly aligns with the overall Government policy to consider selling assets where there is no policy reason to retain them, subject to achieving value for money. In completing each sale, the Government transfers the repayment risk of the loans to the private sector. This policy supports the Government’s commitment to improve fiscal sustainability and reducing net debt.
With regards to considering risk from the loan book as a whole, it is not feasible to
de-risk the entire loan book in a short space of time via sales. It is also worth noting
that whilst the requirement to transfer the risk of the sold loans is an important
consideration for the loan sale programme, it is not the only motivating factor.

Ultimately, Government is seeking to achieve the best value possible from its assets.
A key consideration is whether there is more value to government in selling a loan
sale pool for proceeds up-front, or in retaining those loans at any given point in time.
In doing this, it is important to ensure that exposure to the risk of the loans is truly
transferred.

Ensuring competitive tension in a sale process is important to drive value, and there
is not inexhaustible demand in the markets for the assets, meaning that a small
selection of cohorts must be chosen for each sale. It is true that the current
programme of sales is for the ‘Plan 1’ loan book only (i.e. pre-2012 loans) and that
no decision has been made whether to sell the Plan 2 loans. As would be expected,
the Government must proceed with loan sales in a way that ensures value for money
and minimises execution risk, and these are the principles that have guided the
rationale for focusing on the Plan 1 book (rather than Plan 2) for the current loan sale
programme.

The decision to focus on Plan 1 loans is based upon careful consideration of a
number of factors. In particular, Plan 1 loans benefit from the longest earnings data
history in support of fit-for-purpose modelling and forecasting of repayments. This is
essential as it allows the Government and investors to form a view on the value of
the loans. Currently, the data series available on the earnings paths for Plan 2
borrowers is too limited to allow the long-term projections of cash flows that are
required.

It also does not necessarily follow that selling Plan 1 means the least risky loans out
of the entire HMG-owned loan book are sold. The earlier Plan 1 cohorts that were in
scope of the first and second sales are more seasoned, meaning that higher earners
are more likely already to have paid off their loans.

In addition, the Plan 1 loan book is ‘closed’, which means that new borrowers cannot
take out a Plan 1 loan, and there is a much lower likelihood of changes being made
to the terms of the loans which could affect cash-flows (for example, they were
specifically excluded from the remit of the Post-18 review ). It is also worth noting
that just selling the Plan 1 book is a significant undertaking, with the programme
already scheduled to extend out to 2022–23.

Finally, your letter points out that the loan sale model does not model the entire
portfolio of loans. This is a deliberate decision. Any given sale includes a small
number of cohorts, which are likely to have differing characteristics to the loan book
as a whole. This in turn could drive different repayment profiles. There are also
significantly different underlying terms for the Plan 1 and Plan 2 loans. A model that
is tailored specifically to the sale pool is therefore the correct choice for the sale
programme.
We continue to review the performance of the model against the two data points available in the year. TERM performance prior to the January 2019 interim data update was within acceptable tolerance levels. Following this point, performance continues to be within acceptable tolerances for Sale 1 and Sale 2 (related to the 2017/018 financial year). For Sale 1 the model has recorded a 4.4% under-forecast as compared to the model’s forecast cash-flows for that period, and for Sale 2 there has been an over-forecast of 1.3%. This is within acceptable tolerance levels. Further analysis and review will be carried out on an ongoing basis.

Use of retention value (Recommendation 4)

The value for money assessment does aim to capture a holistic view of the impact of the loan sale by assessing the true economic value of any given sale. Accordingly, it takes into account a number of elements that the National Accounts will not, but which are widely accepted economic principles. A good example is the time value of money, and the opportunity cost to Government of having money tied up in assets which could be used for a different purpose.

In your recent ‘Fourth Annual Report of the Chair of the Committee of Public Accounts’, you set out that Government’s analysis projects the £1.7 billion sale price for Sale 1 would have been recouped within eight years. It is worth noting that the outputs from the model previously shared with the Committee show the Government receiving £1.7bn in undiscounted cashflows within ten years rather than eight.

More importantly, undiscounted forecast cashflows do not represent the value of these loans to Government. Economic and financial theory and practice recognise that using a payback method is an incorrect way to value future cashflows. When calculating the value to Government of retaining an asset, as well as forgone future cashflows, it must also take account of inflation, the riskiness of the asset in question, the opportunity cost of having money tied up in the asset and the time value of money. This is the basis for the Government’s retention value.

The value for money framework for both previous sales of student loans is comprised of three components, only one of which relates to Government’s retention value (which is calculated in a way that is consistent with Green Book methodology). An Accounting Officer judgement on the value for money framework for any given sale has been made using several inputs and sources of evidence, as well as the Government Retention Value Range.

Use of fiscal metrics (Recommendation 2)

Your letter also asked for more information on how a sale’s full impacts on the public finances will be considered. HM Treasury is responsible for fiscal policy, Green Book methodology, updated guidance on the reporting of asset sales, and they have jointly agreed with the Department for Education both the objectives for the first two loan sales and the value for money framework which must be satisfied in making a judgement on whether to execute a sale.
Here, it is worth drawing the distinction between the National Accounts and a review of value for money, which aims to judge the underlying economic benefit or otherwise to Government of selling an asset. As you note, no one single measure in the National Accounts gives a perfect view of the true economic impact of the loan sales — nevertheless, they are important to consider because they are key statistics that are comparable internationally and the Government will continue to do so.

As your letter highlights, the ONS has recently published updated guidance on the treatment of student loans in the National Accounts, including the expected treatment of loan sales. As you would expect, Government will fully consider the loan sale programme in this context, noting that a change in the National Accounting treatment does not impact the economic value of the assets.

Investor disclosure (Recommendation 5)

As you say in your letter, we improved the level of information on investors in our 20 December 2018 report to Parliament in respect of the second sale of student loans. We did so specifically in response to the challenge set by your Committee at our September 2018 appearance to be more transparent. This included specific details of the type of institutional investors involved in the sale. For instance, we gave a breakdown of institutional investors into subcategories such as traditional asset-backed securities investors, insurers' annuity funds, pension funds and alternative asset managers. As set out in the letter to you of 16 May, we do not believe we can provide an even more granular, name-level disclosure without raising a considerable risk of a reduction in the value secured from a sale for the taxpayer.

We are copying this letter to the Comptroller and Auditor General, the Treasury Officer of Accounts and the deputy Chief Executive Officer of UKGI Government Investments.

Yours sincerely

Jonathan Slater
Permanent Secretary
Department for Education

Charles Roxburgh
Second Permanent Secretary
HM Treasury