

Office for
**Budget
Responsibility**

**Fiscal sustainability analytical paper:
Student loans update**

July 2016

1 Introduction and context

- 1.1 Each year since 2011, the Office for Budget Responsibility (OBR) has published a *Fiscal sustainability report (FSR)*, in which we consider the fiscal consequences of *past* government activity, as reflected in the assets and liabilities on the public sector's balance sheet, and the consequences of *future* government activity, through the use of long-term demographically driven projections beyond our latest medium-term forecast horizon.
- 1.2 Due to the uncertainty that has followed the result of the 23 June referendum on the UK's membership of the European Union, we have decided to cancel the *FSR* that we had planned to publish on 12 July. The long-term projections would have been based on our pre-referendum March 2016 medium-term forecast and on assumptions about the future path of migration flows and productivity growth that would be affected by the Government's preferred choice of trade regime outside the EU. So it is likely that some of the conclusions would not be informative at the present time. But, notwithstanding the referendum result, we remain committed to transparency in pursuing our statutory duty to examine and report on the sustainability of the public finances, so where possible we are publishing elements of the analytical work that would have featured in July's *FSR* as 'fiscal sustainability analytical papers'.
- 1.3 In this analytical paper, we present:
- a summary of the **policy setting**, including background and the new policy announcements that have been made over the past year;
 - **updated long-term projections** for the addition to net debt from student loans, focusing on the effects of new policy announcements;
 - **analysis of the key sources of change** to this updated projection relative to those presented in our 2015 *FSR*; and
 - some **conclusions** that can be drawn from this analysis.
- 1.4 In producing this paper we have drawn on the help and expertise of officials from the Department for Education, to whom we are most grateful. The analysis, views and conclusions in this report represent the collective view of the three independent members of the OBR's Budget Responsibility Committee.

2 Policy background

2.1 The Government provides funds to support the provision of higher education, both through grants – including, for example, to universities for teaching and, until this year, to students from lower-income families to cover maintenance – and subsidised loans to students. Annex B of our 2014 FSR discussed the main elements of the student loan funding system and its accounting treatments.

Planned student loan book sales

2.2 At Autumn Statement 2013, the Government announced its intention to sell part of the student loan book, which it expected would raise around £12 billion over five years from 2015-16. This intention was reiterated in several subsequent fiscal events, but at Autumn Statement 2015 the timing of the first sale tranche was pushed back to 2016-17. The implications of this change for our medium-term forecast were discussed in our November 2015 *EFO*. Selling the loan book affects the flow of cash to the Exchequer, with more recorded upfront as sales proceeds, and less in future years, as future loan repayments will flow to the private sector instead. In effect this crystallises losses on the loans sold: the level of debt is permanently higher relative to no loans having been issued, because sale prices will reflect the interest rate and write-off subsidies implicit in student loans.

Policy announcements over the past year

2.3 Since our last student loan projections were published in June 2015, the Government has made nine policy announcements that will have an effect on how lending to students will affect net debt over the long term. The estimated effects of these policies were set out in the financial transactions ‘scorecards’ in the Summer Budget, the Spending Review and Budget 2016. They are summarised in Table 2.1.

2.4 Ordered by the size of their effect on net lending in 2020-21, the announcements are:

- **‘additional maintenance loans for students’**. This converts maintenance grants paid to lower-income students into loans from 2016-17 onwards, reducing public spending on grants and increasing student loan outlays;
- **‘health education: funding reform’**. This replaces tuition and living cost bursaries for students in certain health-related courses – e.g. nurses and allied health professionals – with loans from 2017-18;
- **‘higher education: part-time maintenance loans’**. This extends maintenance loans to part-time students from 2018-19;

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- **‘doctoral loans’**. This establishes a new income-contingent loan of up to £25,000 for doctoral students from 2018-19;
- **‘postgraduate loans: lifting the age cap and widening scope’**. This extends eligibility for loans to master’s students from 2016-17;
- **‘further education: expansion of tuition fee loans’**. This extends further education tuition loans to include those aged 19 to 23 studying for a level 3 or 4 qualification, and for those aged 19 and over studying for a level 5 or 6 qualification. It takes effect from 2016-17;
- **‘extension of masters loans eligibility’**. This further extends eligibility of master’s loans to include three-year part-time courses with no full-time equivalent. It takes effect from 2016-17;
- **‘equivalent or lower qualification bar: STEM exemption’**. This removes the restriction on loans for part-time second degrees in science, technology, engineering or mathematics (STEM) subjects; and
- **‘student loans: repayment threshold freeze’**. This freezes the repayment income threshold for those in receipt of post-2012 loans at £21,000 for five years from 2016-17 onwards, thereby increasing repayments relative to the previous policy setting. It also freezes the threshold at which the maximum rate of interest of RPI + 3 per cent is charged, increasing accrued interest receipts relative to the previous policy setting.

Table 2.1: Effect of the student loans policy announcements over the past year on net debt

	£ million				
	2016-17	2017-18	2018-19	2019-20	2020-21
Additional maintenance loans for students (Summer Budget 2015)	-620	-1535	-2335	-2805	-3050
Health education: funding reform (Spending Review 2015)	0	-230	-620	-990	-1170
Higher education: part-time maintenance loans (Spending Review 2015)	0	0	-115	-335	-570
Doctoral loans (Budget 2016)	0	0	-50	-115	-185
Postgraduate loans: lifting the age cap and widening scope (Spending Review 2015)	-110	-175	-170	-180	-185
Further education: expansion of tuition fee loans (Spending Review 2015)	-80	-125	-200	-200	-185
Extension of masters loans eligibility (Budget 2016)	-10	-20	-20	-25	-30
Equivalent or lower qualification bar: STEM exemption (Spending Review 2015)	0	0	*	-5	-5
Student loans: repayment threshold freeze (Spending Review 2015)	0	30	90	200	360

* Negligible

3 Updated projections

- 3.1 There are four elements to our long-term student loans projections (which are modelled bottom-up for English loans, with other loans and repayments assumed to move broadly in line with English flows). These elements can be grouped into two categories:
- the **cash elements that affect net debt**: these include total cash outlays less repayments, which make up the projection for net lending and the addition to public sector net debt from lending to students; and
 - the **accrued elements that affect net borrowing**: these are determined not by the timing of cash payments or receipts, but by when their permanent effects are recognised. Each year the interest owed to the Government on the loan book rises, as does the interest the Government must pay on its own debt. Both affect net borrowing. Write-offs only affect net borrowing when they crystallise.
- 3.2 This section describes these elements of our latest long-term projections and the biggest sources of change since last year. The next section sets out in more detail how the policy-related changes have been modelled and their long-term effects.

Headline results

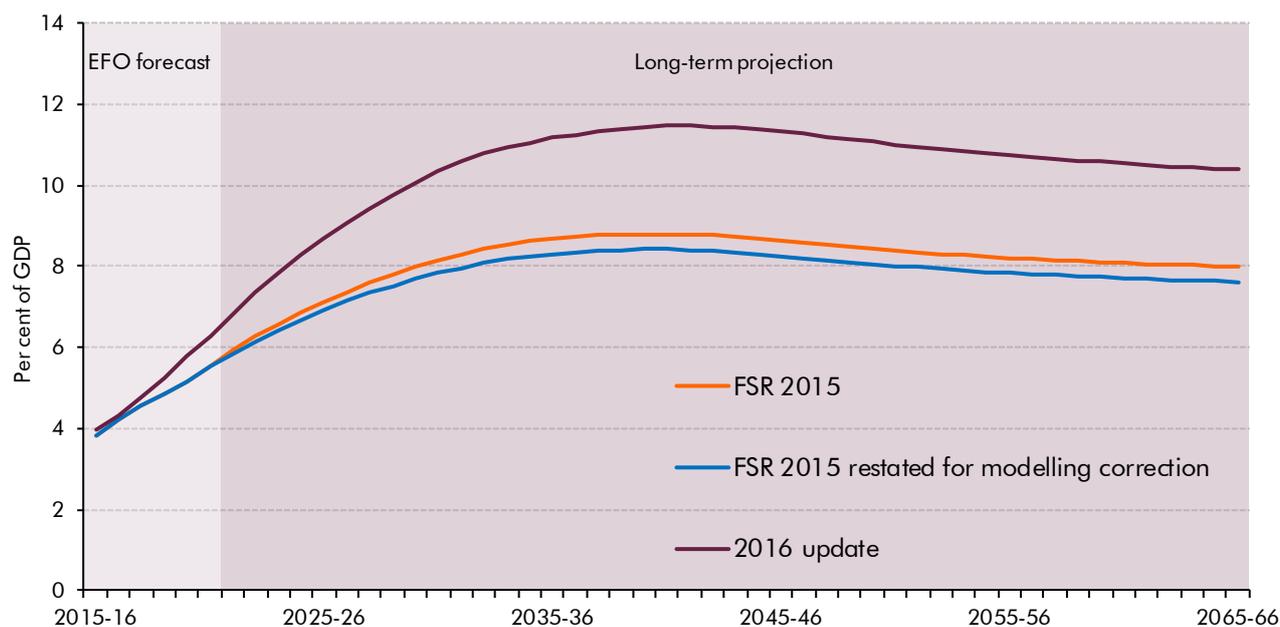
- 3.3 Chart 3.1 shows our updated projections for the addition to net debt from student loans, reflecting loans issued, repayments and the proceeds from loan sales. It shows that our updated projection for the expected addition is significantly higher than last year's, with the effect peaking at 11.5 per cent of GDP in the early 2040s before falling to 10.4 per cent of GDP in 2065-66. We have restated last year's FSR projection in this chart to reflect a modelling correction whereby our medium-term assumptions had not been reflected correctly in the long-term projections. The main effect of that was to underestimate future repayments and overstate the addition to net debt by 0.3 per cent of GDP on average. Relative to that restated projection, the peak effect on debt in our updated projection is 3.1 per cent of GDP higher – and comes a little later. It remains 2.8 per cent of GDP higher in 2065-66.
- 3.4 The biggest factors explaining the upward revision are the net effect of a significant number of new student loans policies announced over the past year. In summary, the 2.8 per cent of GDP increase in the projected addition to net debt in 2065-66 reflects:
- a 2.5 per cent of GDP **net addition from new policy announcements**. That is made up of a 3.3 per cent of GDP gross addition from policies that extend the use of student loans, partly offset by a 0.8 per cent of GDP gross reduction from the decision to

Updated projections

freeze the repayment threshold for post-2012 loans at £21,000 for five years from 2016-17; and

- a 0.3 per cent of GDP **addition due to other factors**. Among these are the effects of the new population projections that were published by the Office for National Statistics in October 2015.

Chart 3.1: Additions to net debt from student loans

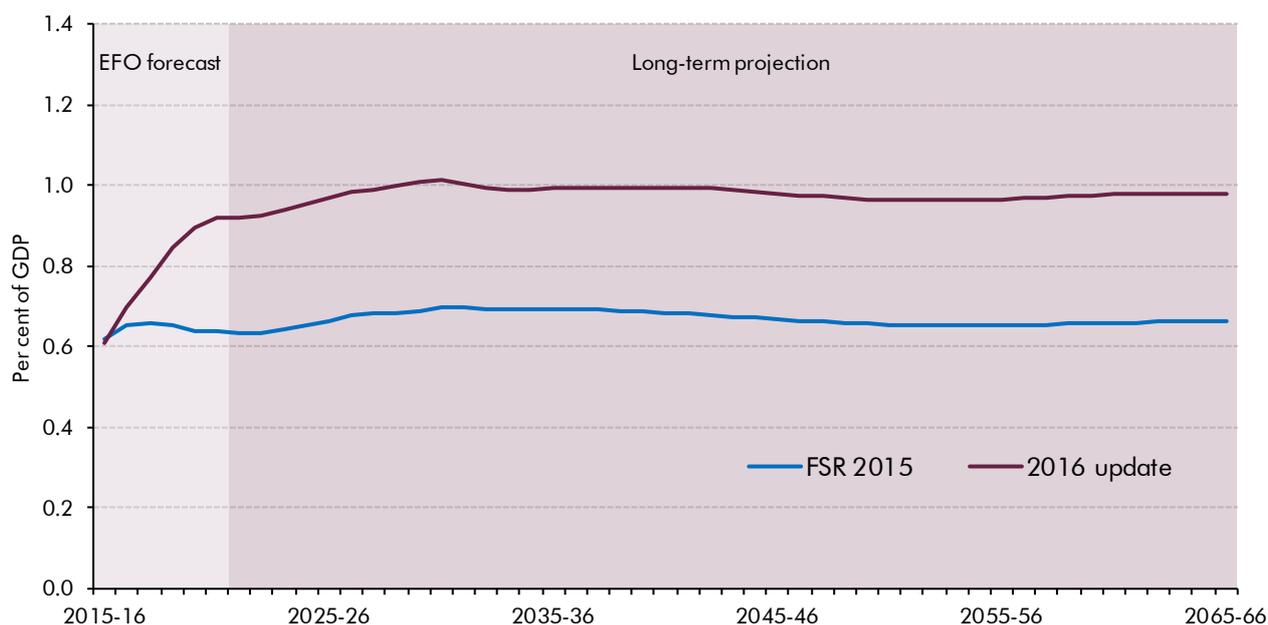


Source: OBR

Outlays, repayments and net lending

3.5 Chart 3.2 shows that our updated bottom-up projection for English post-2012 student loan outlays settles at around 1.0 per cent of GDP in the long term, around 0.3 per cent of GDP higher than projected in last year's *FSR*. That difference is almost entirely explained by the new policies listed in the previous section, in particular the conversion of maintenance grants to loans for lower-income students and replacing bursaries with loans for nurses and others undertaking certain health-related courses.

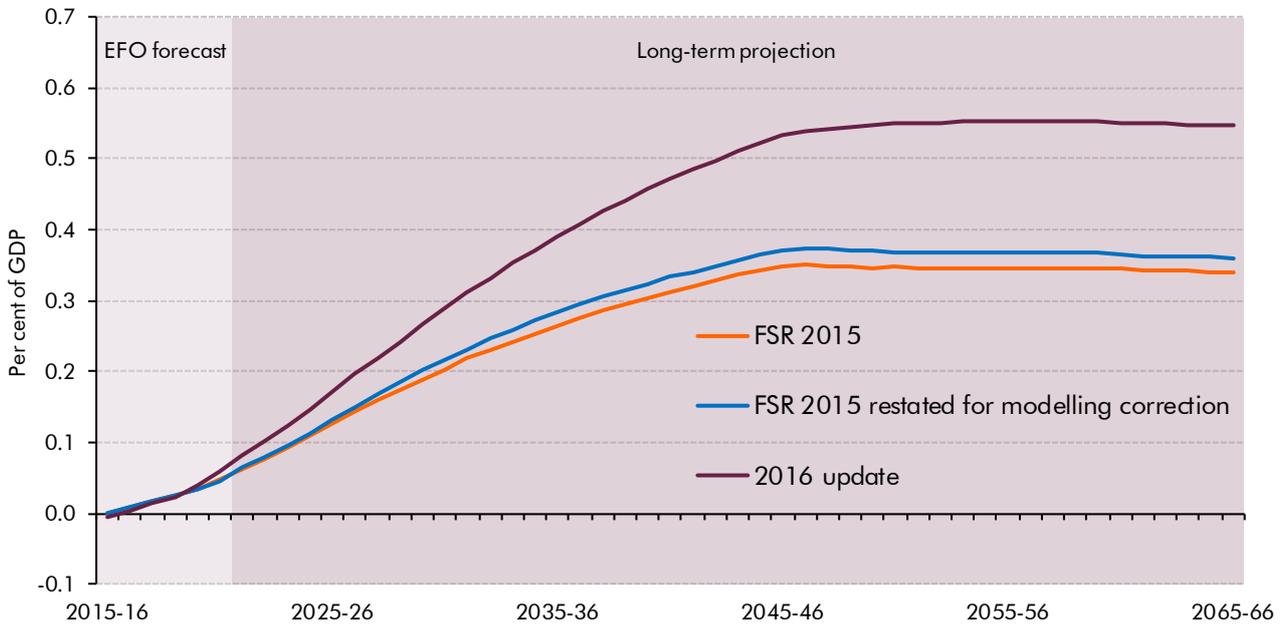
Chart 3.2: Projected cash outlays on English post-2012 loans



Source: OBR

3.6 Chart 3.3 shows that our projection for repayments associated with the English post-2012 loan book rises to over 0.5 per cent of GDP by the mid-2040s, when the first cohort of students that received loans under the new system approach the end of their 30-year repayment cycle. Relative to last year's FSR, the updated projection is around 0.2 per cent of GDP higher. Around a tenth of that difference is explained by a correction to last year's modelling, in which our medium-term student numbers forecast was not reflected properly in the long-term modelling. But, as with outlays, the main source of the upward revision has been new policies, in particular freezing the income threshold at £21,000 for five years from 2016-17. All the policies that increase outlays in the medium term will also increase repayments in due course. These effects are detailed in the next section.

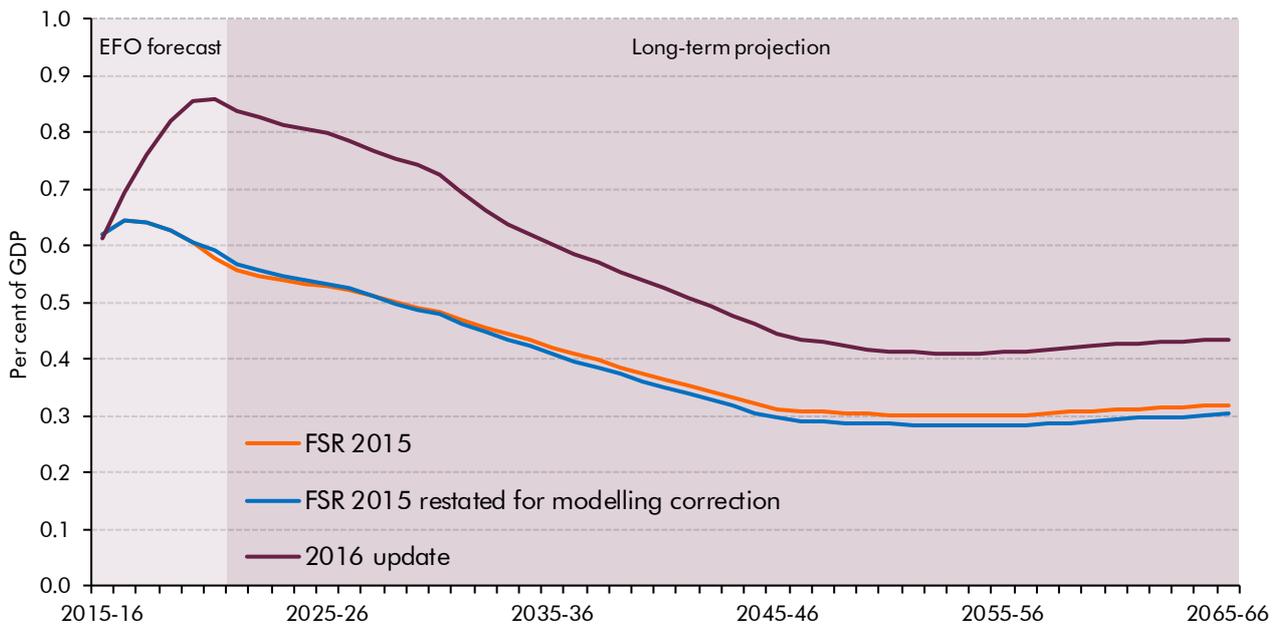
Chart 3.3: Projected cash repayments on English post-2012 loans



Source: OBR

3.7 Chart 3.4 combines outlays and repayments to show our projection for net lending on English post-2012 loans. With the upward revision to outlays being greater and more front-loaded than the upward revision to repayments, net lending has been revised up in every year and by more at the start of the projection than the end.

Chart 3.4: Projected net lending on English post-2012 loans

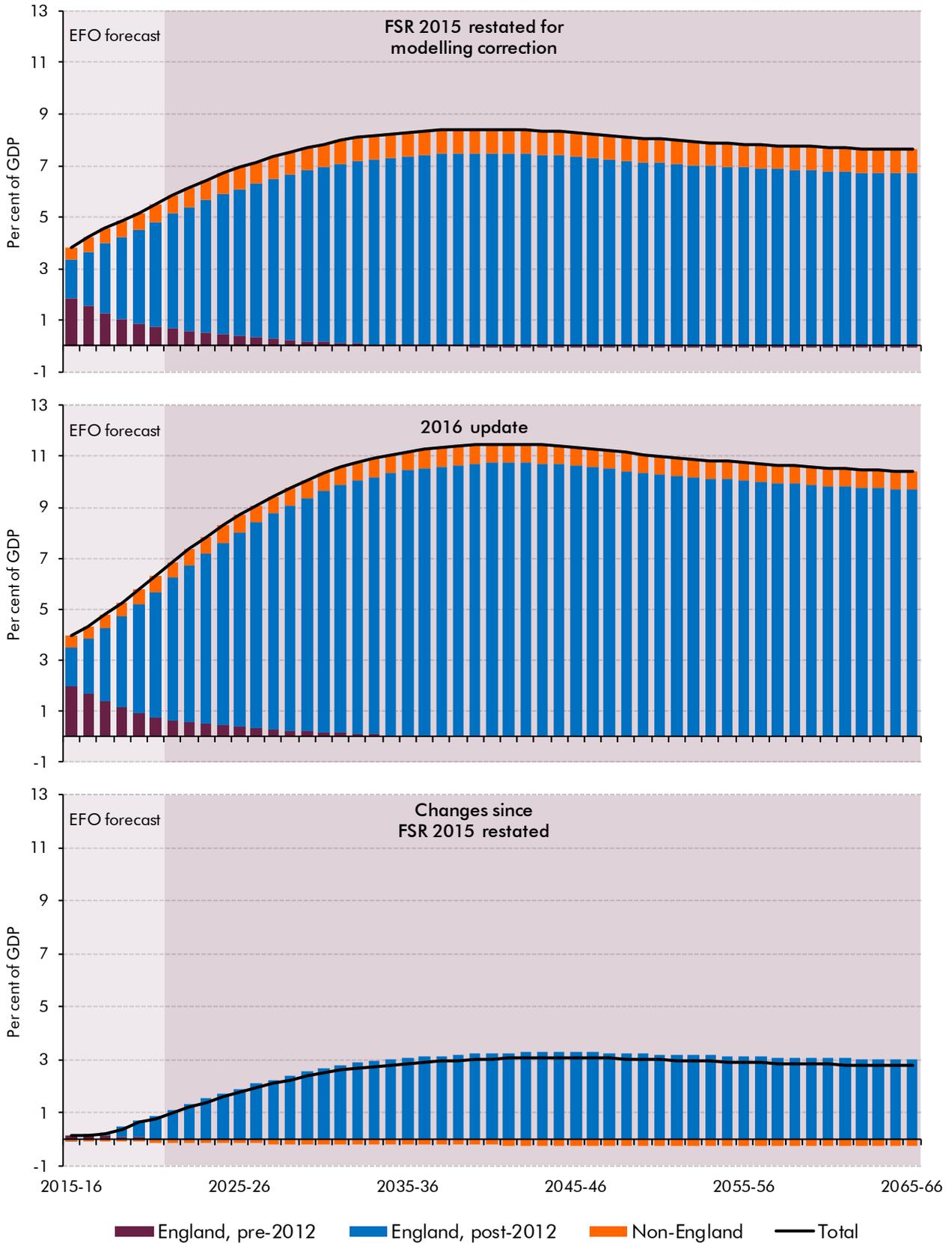


Source: OBR

Additions to net debt

3.8 Chart 3.5 shows how these bottom-up projections for net lending on English post-2012 loans – plus top-down assumptions for other lending – translate into additions to net debt. It shows that we have revised up the projected addition significantly, with the effect peaking at 11.5 per cent of GDP in the early 2040s before falling to 10.4 per cent of GDP in 2065-66. Relative to last year's *FSR* projection – restated for the correction described above – the peak effect on debt in our updated projection is 3.1 per cent of GDP higher – and comes a little later. It remains 2.8 per cent of GDP higher in 2065-66. A decomposition of this revision is shown in Chart 3.8 in the next section.

Chart 3.5: Additions to net debt from student loans: previous projection, updated projection and changes



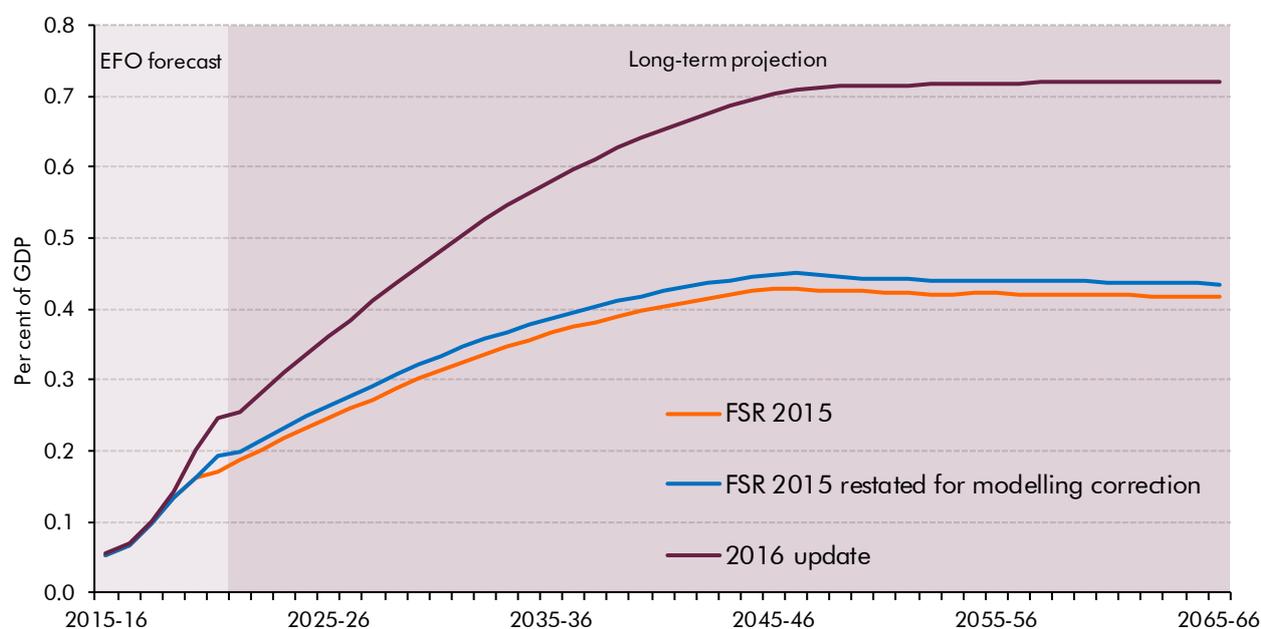
Source: OBR

Accrued interest and write-offs

3.9 Chart 3.6 shows that our projection for accrued interest income associated with the English post-2012 loan book increases from 0.25 per cent of GDP in 2020-21 to around 0.7 per cent of GDP by the mid-2040s, from which point it stabilises at around 0.3 per cent of GDP higher than in last year's *FSR*. That change reflects two main factors:

- the **higher stock of loans outstanding** due to higher net lending; and
- the **impact of the threshold freeze policy**, which means that more loans are assumed to accrue interest at higher interest rates because the interest rate to be applied to each rises above a specified earnings threshold.

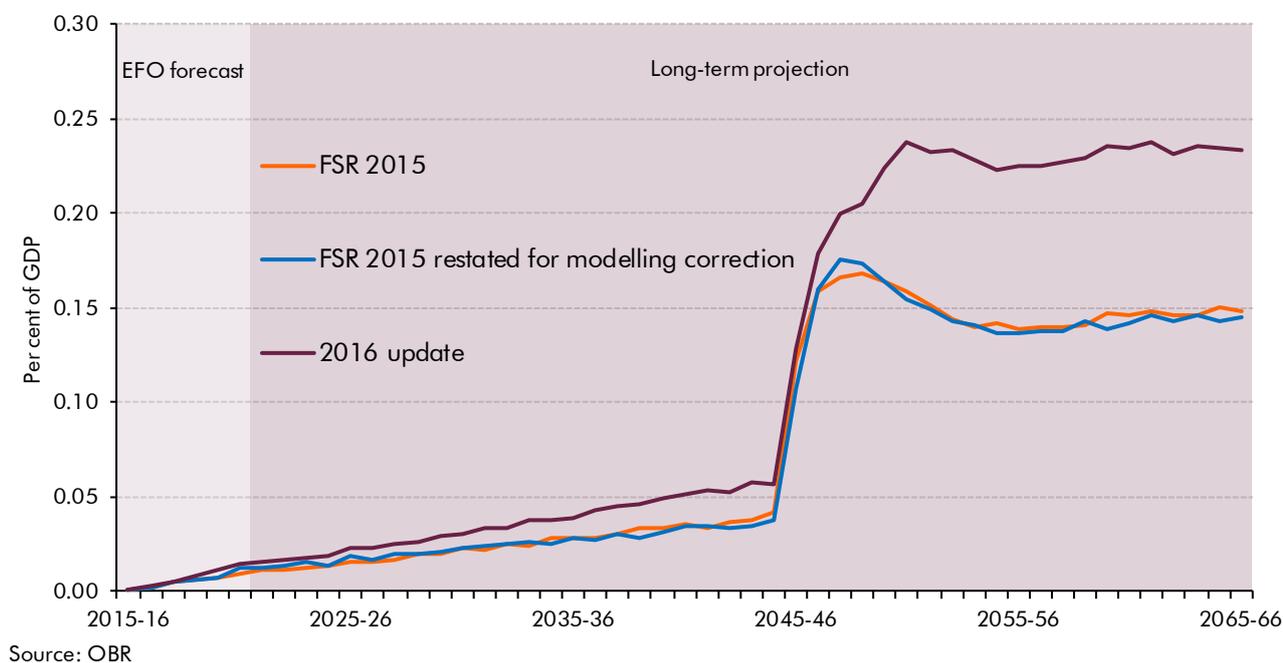
Chart 3.6: Projected accrued interest on English post-2012 loans



Source: OBR

3.10 Chart 3.7 shows our implied projections for future write-offs. These will affect net borrowing as they are crystallised, but will only affect net debt indirectly, due to the absence of repayments thereafter. We project only small amounts of write-offs up to the mid-2040s, when the first cohorts of graduates that received loans under the post-2012 system will have any outstanding loans written-off. Thereafter, write-offs rise to a little over 0.2 per cent of GDP a year. The upward revision since last year of almost 0.1 per cent of GDP a year from the early-2050s is a knock-on effect from the upward revision to outlays as a result of new policies. More than half the upward revision is explained by the policy that converts low-income maintenance grants to loans, which is both large in terms of outlays and expected to experience a higher proportion of write-offs than the overall student loan book.

Chart 3.7: Projected write-offs on English post-2012 loans

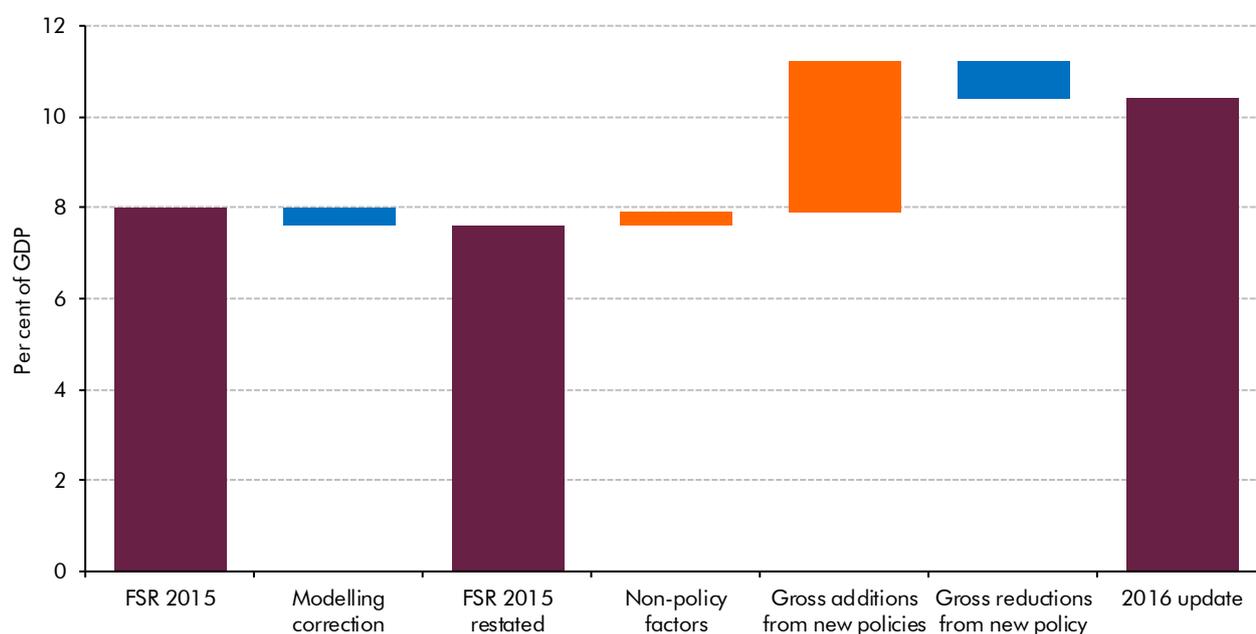


Sources of changes to the central projection

3.11 Chart 3.8 shows the main steps that explain why our updated projection for additions to net debt from student loans in 2065-66 is higher than last year's FSR projection:

- the **correction to last year's modelling**, in which our medium-term student numbers forecast was not properly reflected in the long-term modelling, lowers the projection by 0.4 per cent of GDP;
- other changes to our **pre-policy-measures assumptions** add 0.3 per cent of GDP. This reflects a number of relatively small factors, including a lower medium-term forecast for non-English student loans and basing the long-term projections for student numbers on new 2014-based ONS population projections;
- **gross additions from new policies** total 3.3 per cent of GDP, with the largest effects coming from the conversion of maintenance grants to loans for students from lower-income households and replacing bursaries with loans for nurses and others studying certain health-related courses; and
- **gross reductions from new policy** total 0.8 per cent of GDP, explained entirely by the 5-year freeze from 2016-17 of the income threshold at which graduates must begin making repayments on post-2012 loans.

Chart 3.8: Changes to additions to net debt from student loans in 2065-66



Source: OBR

3.12 Tables 3.1 and 3.2 set out in detail how the new policies announced over the past year have affected the final year of these updated projections. They show that:

- the **decisions to convert maintenance grants or bursaries to loans** for students from lower-income households and for nurses and others on certain health-related courses have had the biggest effects on most elements of the updated projections. They account for over three-quarters of the policy-driven increase in outlays and a higher proportion of the increase in write-offs. Lending to students from lower-income households has a large effect on write-offs because the main recipients of these loans will be students that already receive large fee and maintenance loans, so they will only start making repayments on the extra loans when (and if) they have fully repaid the other loans. And as we noted in our July 2015 *Economic and fiscal outlook*, when this policy was announced – if lifetime earnings are positively correlated with parental household income, write-off rates on these loans would be higher than in the student loan population as a whole. These policies also more than account for the policy-driven increase in the addition to net debt. The effects of these policies have been modelled using the full BIS student loans model;
- the **decision to freeze the income threshold at which repayments on post-2012 loans must begin** has had the biggest effect on repayments and is the only factor reducing the addition to net debt relative to last year's FSR projection. The freeze is only in place for five years from 2016-17, but its effect then cumulates over time because subsequent assumed increases in the threshold start from a lower level. It accounts for over 30 per cent of the policy-driven upward revision to repayments. This policy has also been modelled using the full BIS model;

- **other policies that increase lending to those on undergraduate courses and in further education** have had a material effect on cash and accrued flows. The long-term effects of these policies have been modelled on the basis of the scorecard costings presented in Table 2.1 and then scaling future flows relative the full-time undergraduate loans projections. There is therefore greater uncertainty around these projections; and
- **policies that increase lending to postgraduate students** have also increased projected cash and accrued flows over the long term. The effects have also been estimated using a simpler scaling approach. They have a slightly different composition to the other additions to lending. For a given change in outlays, they have a bigger effect on repayments (in large part because postgraduates are assumed to have higher earnings and therefore repay larger amounts) and a smaller effect on write-offs (for the same reason). They also have a bigger effect on accrued interest, because postgraduate loans will on average have a higher interest rate applied – of RPI + 3 per cent for all loans, rather than just those above a specified earnings threshold in the case of undergraduate loans.

Table 3.1: Sources of changes to outlays, repayments, write-offs and accrued interest in 2065-66

	£ billion				
	Outlays	Repayments	Net lending	Write offs	Accrued interest
FSR 2015	132.5	68.4	64.1	29.8	83.9
Modelling correction	0.7	4.1	-3.4	-0.7	3.5
FSR 2015 restated for modelling correction	133.2	72.4	60.8	29.2	87.4
2016 update	192.4	107.4	85.0	45.8	141.1
Change	59.2	35.0	24.2	16.7	53.7
<i>of which:</i>					
Non-policy factors	8.9	5.7	3.2	3.0	9.3
Policy changes	50.3	29.3	21.0	13.7	44.4
<i>of which:</i>					
Low-income maintenance grants to loans	28.0	7.8	20.3	10.4	21.9
Health-related bursaries to loans	10.8	4.3	6.5	3.4	6.8
Other undergraduate and further education loans	5.4	2.5	2.8	1.7	3.7
Postgraduate master's and doctoral loans	6.1	5.6	0.5	1.3	8.8
Repayment threshold freeze	0.0	9.1	-9.1	-3.1	3.1

Table 3.2: Sources of changes to the addition to net debt in 2065-66

	Per cent of GDP
FSR 2015	8.0
Modelling correction	-0.4
FSR 2015 restated for modelling correction	7.6
2016 update	10.4
Change	2.8
<i>of which:</i>	
Non-policy factors	0.3
Policy changes	2.5
<i>of which:</i>	
Low-income maintenance grants to loans	2.1
Health-related bursaries to loans	0.7
Other undergraduate and further education loans	0.3
Postgraduate master's and doctoral loans	0.2
Repayment threshold freeze	-0.8

Updated projections

4 Conclusion

- 4.1 In this paper we have provided an update to our long-term projections for the addition to public sector net debt from student loans published in our 2015 *FSR*. Since that report, the Government has announced a significant number of new student loans policies over the course of three fiscal events.
- 4.2 We now project that lending to students will add 10.4 per cent of GDP to net debt in 50 years' time, with policy changes announced since last year having increased that figure by 2.5 percentage points. Most notably, the conversion of maintenance grants to loans for students from lower-income households and replacing bursaries with loans for nurses and others studying certain health-related courses more than explain the increase since last year's *FSR*. This large increase is only partially offset by gross reductions resulting from the 5-year freeze from 2016-17 of the income threshold at which graduates must begin making repayments on post-2012 loans.

