Sale of Pre-2012 (Plan 1) Income Contingent Student Loans

Presented to Parliament pursuant to section 4 of the Sale of Student Loans Act 2008.

Introduction

1. On 6 December 2017, the Government priced the sale of circa 1.2m loans issued by English Local Authorities that entered repayment between 2002 – 2006 via a securitisation process by the Department for Education, acting on behalf of HM Government.

2. The purpose of this report is to set out the detail of the transfer arrangements and to give Parliament information about the extent to which the arrangements give good value, reflecting any guidance given by the Treasury about assessing value for money, as is required by Section 4 of the Sale of Student Loans Act 2008.

3. The report is presented in the following structure:
   1. Rationale for the sale
   2. The objectives of the sale
   3. The approach taken (sale arrangements)
   4. Value for Money assessment

Rationale for the sale

4. The Government's objective when issuing loans to students is to allow them to pursue their education regardless of their personal financial situation. Once this objective has been met, however, retaining the loans on the Government's balance sheet serves no policy purpose.

5. Selling financial assets, like student loans, where there is no policy reason to retain them, and value for money can be secured for the taxpayer, is an important part of the Government's plan to repair the public finances. Asset sales free up resources which can then be put to use for purposes or policies which have greater social or economic returns.

The objectives of the sale

6. When the Government first announced its intention to sell the pre-2012 English student loan book in 2013, it agreed the following objectives:

- Ensuring a sale leads to a reduction in Public Sector Net Debt (PSND) and does not significantly impact Public Sector Net Borrowing (PSNB);
- Ensuring a sale does not involve the terms of the loans being altered to the borrowers' detriment or have a negative impact on Higher Education policy objectives of providing access to education; and
- If taken forward, that a sale represents value for money for the taxpayer and has a reasonable expectation of being repeated.

<u>The approach taken (sale arrangements)</u>

7. The Government has priced the sale of a pool of loans issued by English Local Authorities under the previous pre-2012 system, specifically those which entered repayment between 2002 and 2006. A total of circa 1.2m pre-2012 English loans held by approximately 411,000 borrowers have been sold.

8. The loans sold had the following characteristics:

- Interest is capped at the lower of RPI or Base Rate + 1%[1].
- Repayment under a Plan 1 ICR Loan becomes due in the April after a borrower leaves their course (known as the Statutory Repayment Due Date or "SRDD"). Repayments are due only when the borrower's income is over the repayment threshold level (set at £17,335 from 6th April 2015 to 5th April 2016), which increases annually in line with RPI.
- Borrowers pay 9% of earnings over the threshold. The repayment terms can be changed by new secondary legislation. Government has no plans to change, or to consider changing, the terms of pre-2012 loans.
- Creditworthiness is not considered as part of the loan issuance process
- ICR Loans are advanced to eligible borrowers on identical terms regardless of creditworthiness or any differential in anticipated future earnings. Availability of the loan is subject only to the borrower taking a qualifying HE course and satisfying certain residency conditions.

Impact on borrowers

9. The Government has been clear throughout the sale process that borrowers, including those whose loans have been sold, will not be affected by the sale. The sale arrangements ensure that the sale does not and cannot in any way alter the mechanisms and terms of repayment. Sold loans will continue to be serviced by Her Majesty's Revenue and Customs (HMRC) and the Student Loans Company (SLC) on the same basis as unsold loans. Purchasers have no right to change any of the current loan arrangements or to directly contact borrowers.

10. Those borrowers whose loans have been sold will be notified in writing by the Student Loans Company within 3 months of the sale being completed - this

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[1] For five of the past six years, the interest rate has been capped at Base Rate +1% and the current interest rate is 1.5% from 1 December.

notification is for information only. No action will be required by borrowers as a result of the sale.

11. As the Government has previously made clear, borrowers' personal data will not be disclosed to investors. Student loans data is not shared with credit reference agencies and will not impact on an individual's credit score (either positively or negatively).

Sale structure

12. The sale took place by means of a securitisation. This involved transferring the loan pool to a new independent English-domiciled company ("the Issuer"). This company is registered as 'Income Contingent Student Loans 1 (2002-2006) Plc'. In turn the Issuer has issued to investors securities in the form of notes representing the rights to the remaining future repayments. The Issuer will receive repayments from borrowers on the underlying loans and distribute payments of interest and principal to investors.

13. Securitising the loans allows the Government to sell to investors notes which have different characteristics, maximising value from the sale for the UK taxpayer by creating separate tranches of securities for a wide-range of different potential investors, for example pension funds and insurance firms. This promotes both the creation of an efficient market and efficient pricing, but it also means investors do not own an identifiable set of loans, they simply own access to an agreed share of the overall loan book.

14. Four separate tranches of notes of varying seniority, maturity and interest rate have been issued:

- Class A1: Senior, pass-through investment grade notes with an estimated weighted average life of 2.9 years and a coupon linked to one year sterling LIBOR
- Class A2: Senior, amortizing investment grade notes with an estimated weighted average life of 11.5 years and a fixed rate coupon
- Class B: Mezzanine, investment grade notes with an estimated weighted average life of 12.5 years and a coupon linked to LPI
- Class X: Subordinated notes with a running coupon of 0.5% and providing an entitlement to any residual cash flows.

15. The noteholders will receive payments from the Issuer annually following the annual transfer of repayments from Government to the Issuer. Cashflows under the notes will be distributed in accordance with a pre-set priority of payments with the Class A noteholders paid first (following the payment of fees and expenses) and junior investors (Class X noteholders) receiving any residual amounts after other noteholders are paid. There is no obligation on Government to make up any shortfall should the loans economically underperform.

16. This securitisation is a rated transaction with a listing on the official list of the UK Listing Authority ("UKLA") and admitted to trading on the London Stock Exchange's regulated market with respect to all tranches other than the Class X notes.

17. The rated notes issued by the Issuer in this securitisation structure have to comply with capital requirement regulations[2]. As a result, Government is required to retain a randomly selected 5% of the amount being sold. These assets will remain on HMG's balance sheet and for accounting purposes would be treated in the same ways as unsold loans. HMG will not purchase or otherwise hold any of the Issuer's securities.

Arrangements for Servicing the Loans

18. Under the sale arrangements sold loans will continue to be serviced by HMRC and SLC on exactly the same basis as equivalent unsold loans, with the Secretary of State for Education having contractual responsibility for collecting repayments on the loans for investors.

19. As is common practice in a debt securitisation, a specific Master Servicer function has been created to oversee the servicing of the sold loans and provide one point of contact for investors. The Master Servicer will consist of a small team of Department for Education and UK Government Investment officials overseen by a board chaired by a Senior Civil Servant. The operating costs of this arrangement will be covered by investors through an annual fee. Under the sale arrangements there is no scope for investors to appoint a third-party servicer.

20. This arrangement will be subject to detailed governance and assurance processes, including an annual audit of HMRC and SLC controls in place, to enable Government to ensure that it is meeting its contractual obligations under the sale.

Contingent Liabilities

21. As with every market transaction, the sale arrangements include a number of warranties and indemnities for sale arrangers and investors which give rise to contingent liabilities for Government. Details of these liabilities were reported to Parliament on 31 October 2017 by the Minister of State for Universities, Science, Research and Innovation via a Written Ministerial Statement.

Value for Money Assessment

22. When considering whether the sale arrangements delivered good value for the taxpayer, the Government followed the guidance set out in HM Treasury's Green Book for assessing public spending decisions and the supplementary guidance "Value for money and the valuation of public sector assets". HM Treasury also provided a framework for applying this guidance to assess whether a sale of student loans represents value for money for the taxpayer.

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[2] Article 405 of the Capital Requirements Regulation (Regulation (EU) No 575/2013), which governs the risk retention requirements for regulated investing institutions.

23. The framework set out three key tests to ensure the sale represented value for money:

- that an **efficient market** exists for this asset
- that the sale is structured and executed in such a way as to promote **efficient pricing**
- that the **sale value exceeds the Government Retention Value** (calculated using HM Treasury Green Book principles).

Efficient Market

24. For an efficient market to be present, investors needed to be able to make an accurate judgement of the value of the asset and there needed to be sufficient demand for the asset so as to create sufficient competition between investors.

25. In the months leading up to the sale, the Government and its advisers monitored market conditions closely to ensure that there was an appropriate market window to execute the transaction. At the point of sale, market conditions were supportive of securitisation issuances, and feedback from investors confirmed there would be sufficient market capacity to buy the assets. The Government and its advisers were satisfied that there were no market distortions that would have suggested the markets were not operating efficiently and considered that, given the low interest rate environment, market conditions were more likely to deteriorate than improve.

26. Before formally opening the books, the Joint Lead Managers (“JLMs”) acting on behalf of Government in the market gathered indications of interest from investors which suggested demand would be strong across all tranches. The JLMs therefore advised HMG that they were confident a transaction could be executed and that there would be competition for the loan notes, allowing the Accounting Officer to conclude the efficient market test would be met.

27. The formal sale process confirmed these assessments of the extent of market demand, with interest from a wide range of investors. The eventual interest and firm orders for notes exceeded the supply, generating competition for the notes, which helped to drive up pricing. This was true across all tranches of the capital structure, with an eventual coverage of the tranches at clearing price being:

    a. A1 note: 129%
    b. A2 note: 183%
    c. B note: 255%
    d. X note: 207%

Efficient Pricing

28. The efficient pricing test required that the sale was executed in a way that promoted best value through an open and competitive process. As part of this process,

investors needed to be able to make an accurate judgement of the value of the loans for sale based on an analysis of their risk and return characteristics.

29. Following standard practice, Government, aided by its financial advisers, engaged widely with potential investors and credit ratings agencies to assess potential levels of demand using different routes to market. These market testing exercises allowed the Government to determine that the securitisation structure would ensure the highest level of demand from a broad range of investors. This process was specifically designed to appeal to a wide range of potential investors to ensure that pricing tension could be achieved.

30. Again following standard practice, Government made available an extensive suite of information in order to ensure a wide range of investors could participate in the transaction and make an accurate assessment of the value of the loans. Investors also had access to the analysis performed by ratings agencies Standard and Poor's and Fitch, who provided an assessment of the credit quality of the rated (A and B) notes.

31. As is normal for such transactions, through a Virtual Data Room (VDR), investors were provided with a comprehensive Sale Prospectus, Sales and Servicing Presentations, an indicative financial model of the cash flows, a report on the certain regulatory aspect of the loans, and access to anonymised data on the loan book. During the sales process, investors were also given access to industry-standard tools to analyse various cash flow scenarios and were able to pose questions which were then answered and those answers shared with the entire investor community who had registered to the VDR.

32. The price discovery process for each tranche of notes being sold was carried out using a market standard bookbuilding process. This process solicited bids for investors based on indications of their price and volume interest for the notes. The bookbuild was designed to encourage maximum competition between bidders for the notes and to therefore deliver the highest price. The price at which there was sufficient demand to sell each of the tranches was used to set the clearing price.

33. In addition to structuring a process designed to deliver optimum value, the Government also made a quantitative assessment of what a long term efficient price for the assets might be based on their intrinsic risk/reward characteristics. This analysis, which was based on an assessment carried out by the Government Actuary's Department, helped the Accounting Officer to assess whether the process had been successful in delivering an efficient price for a first sale.

34. During the formal transaction process which followed market practice for bookbuilding processes, the Government first issued Initial Pricing Thoughts ("IPTs") to guide investors on the approximate range of pricing expectations. These were based on an assessment of investors' price expectations gathered during a market testing exercise, as well as the price of other market securities. Subsequently, as formal orders were received, a few days into the bookbuild process Government

followed market practice and issued Price Guidance, tightening the pricing ranges and narrowing spread expectations (in other words increasing the cash price of the securities). Following this Price Guidance, the Joint Lead Managers were able to generate further price tension and walk investors up the price ranges so that the prices could be further tightened. This progress in increasing the final sale price during bookbuilding is illustrated in the table below.

Prices expressed as **(% of face value)**	**IPTs (28 November)**	**Price Guidance (4 December)**	**Final pricing (6 December)**
A1	98.6% area	98.6%-99.3%	99.03%
A2	88.8%-90.8%	91.0%-93.1%	93.123%
B	84.5% area	84.5%-86.5%	86.55%
X	7%-8%	8%-8.5%	8.5%

Comparison of sale price and retention value

35. As set out in the Department for Education's annual accounts, student loans are held on the balance sheet at a value determined on the basis of International Financial Reporting Standards (a "carrying value"). This value represents the face value of all the loans issued less an estimate of the proportion of the loans that will not be repaid. The DfE annual report sets out in more detail how this carrying value is calculated.

36. For asset sales, however, in line with HMT's Green Book and supplementary guidance "Value for money and the valuation of public sector assets", the Government must take account of the time value of money in order to estimate its "retention value". It must consider the effect of inflation, the riskiness of assets and the opportunity cost of having money tied up in an asset. The opportunity cost reflects the fact the Government must make choices between different alternatives for the use of this money, and these choices are made within a fixed spending and investment envelope. In order for the sale to represent value for money for the taxpayer from a purely quantitative perspective, the price offered by a buyer needed to be higher than or broadly in line with this retention value.

37. In determining whether to sell the loan book, the Government assessed the expected sale price and retention value at numerous key milestones in the sales process, with the Accounting Officer for the Department for Education taking advice from officials in HM Treasury, UK Government Investments, his own officials and from a range of appointed external advisers.

38. The Government uses the HM Treasury Green Book guidance for all investment and asset management decisions. This ensures a consistent and rational approach based upon rigorous, evidence-based and peer-reviewed frameworks for financial decision making.

39. The retention value was calculated by discounting the forecast student loan repayments using the HM Treasury Green Book discount rate for asset sales. This incorporates the Social Time Preference Rate (STPR), as well as additional considerations such as inflation and the risk characteristics of the assets for sale to which Government would be exposed as the loan holder. The Social Time Preference Rate represents the value society places on having a pound now compared to a pound in the future and it allows Government to make a fair and consistent comparison across a whole range of future spending and investment options. It would not be right to use the Government's cost of borrowing, or the gilt rate, to estimate the retention value of the assets because this would not reflect the opportunity cost of having money tied up instead of available for other uses.

40. The price offered in aggregate across the book was £1.7bn, which was above the retention value calculated by Government, and the Accounting Officer therefore concluded the quantitative test had been met.