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Kenneth Gibson MSP
Convener
Finance and Public Administration Committee
The Scottish Parliament
Edinburgh
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Dear Kenny,

At the Finance and Public Administration Committee evidence session on the Spring Budget Revision on 8 March, I agreed to write to the Committee to clarify the following matters raised by Liz Smith, MSP, Michelle Thomson, MSP and Douglas Lumsden, MSP.

Student loans:

Ms Smith, Mrs Thomson and Mr Lumsden all raised questions around the £298.7 million reduction to the Student Loans 'RAB charge'. To reiterate a point that was made in the Committee, this is non-cash adjustment which does not impact Scottish Government discretionery expenditure. It is an adjustment to reflect a change in valuation which considers the extent to which student loans issued to Scottish students will be repaid.

There is a complex calculation which supports this adjustment and I agreed to provide additional information on both the in-year adjustment as well as the basis for the modelling. Included in Annex 1 is a document prepared in conjunction with the Student Award Agency Scotland (SAAS) which provides further details of these matters.

Higher Education and Student Support

Ms Smith asked for a breakdown of the £15m included as Covid expenditure to date within Higher Education and Student Support. The £14.571m (£15m rounded) Covid spend is comprised of three strands of discretionary funding:

- £5.521m of the 20-21 Covid funding allocation, where agreement was given for these funds to be carried forward into 21-22.
- £5.1m of 21-22 Summer Covid discretionary support.
- £3.950m of 21-22 additional Covid discretionary funding.

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I would again note that this is a conservative estimate of the Covid spend to the 31st December, nor does it reflect non-Covid expenditure on Higher Education and Student Support more broadly.

Total Covid funding of £27.9m was allocated to Higher Education Student Support. As the monies are all discretionary funding, the full balance is issued in advance to institutions for them to utilise as required, to support students experiencing financial hardship.

Based on the most recent budget monitoring exercise HESS is forecast to spend within 2.5% of its total post-SBR resource budget of £414.616m.

<u>Clarification</u>

I also wanted to take this opportunity to clarify a response I gave to the committee. I was asked when the Scotland Specific Economic Shock provisions that are currenty in place would end. I mistakenly said these would end in April 2023. These provisions will cease following the end of financial year 2023/24.

I hope this assists the Committee.

TOM ARTHUR

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Annex 1.

Modelling for student loans

1. To forecast student loan repayments and calculate the Resource Accounting and Budgeting (RAB) charge, an earnings model and a repayments model is used to predict outcomes for student borrowers. The earnings model calculates earnings "paths" for individual borrowers after graduation and the repayment model takes these earnings paths, and applies a number of repayment rules to generate the repayments. The earnings model uses input variables such as course level, domicile and subject studied to give the predicted output. The repayment model uses macroeconomic forecasts such as Retail Price Index (RPI) inflation, interest rates and earnings growth to predict the earnings "paths", which then predicts the final amount of student loans that will be repaid. The model uses a regression-based approach with earnings history as a predictor of future earnings, along with age, gender and qualification level to give a more accurate estimate.

Discount rate

Why do we discount student loans?

2. In general, discounting is done to capture the present value of a liability. In the case of student loans, we take into account two things when discounting: 1) RPI inflation and 2) the cost of government borrowing, defined as the HMT real financial instruments discount rate. Both the RAB charge and stock charge are impacted by discounting.

What is the HMT financial instruments discount rate?

3. The real financial instruments discount rate represents the government's long term cost of borrowing, and is determined in large part by the rate at which the government can borrow from investors through selling bonds (via products known as "gilts"). It is represented as a single rate using a historic average over the last 10 years of the yield on a mean maturity of gilt stock. The value since the last update in December 2015 has been +0.7.

Why is it changing now?

4. Yield curves published by the Bank of England show how the returns to investors on gilts have changed significantly over time (see chart 1 below). For example 10-year gilts have been negative and trending downwards since 2014. They are a lot lower than over the 10 years up to the last discount rate setting. This shows that returns to private investors on government bonds are reducing, i.e. the cost to government of borrowing is reducing. Investors used to get more than RPI interest on gilts, and now they get RPI minus a few percentage points. The recalculated real financial instruments discounts rate set by HMT is -1.1 rather than +0.7 to reflect the reduced cost of borrowing to government.

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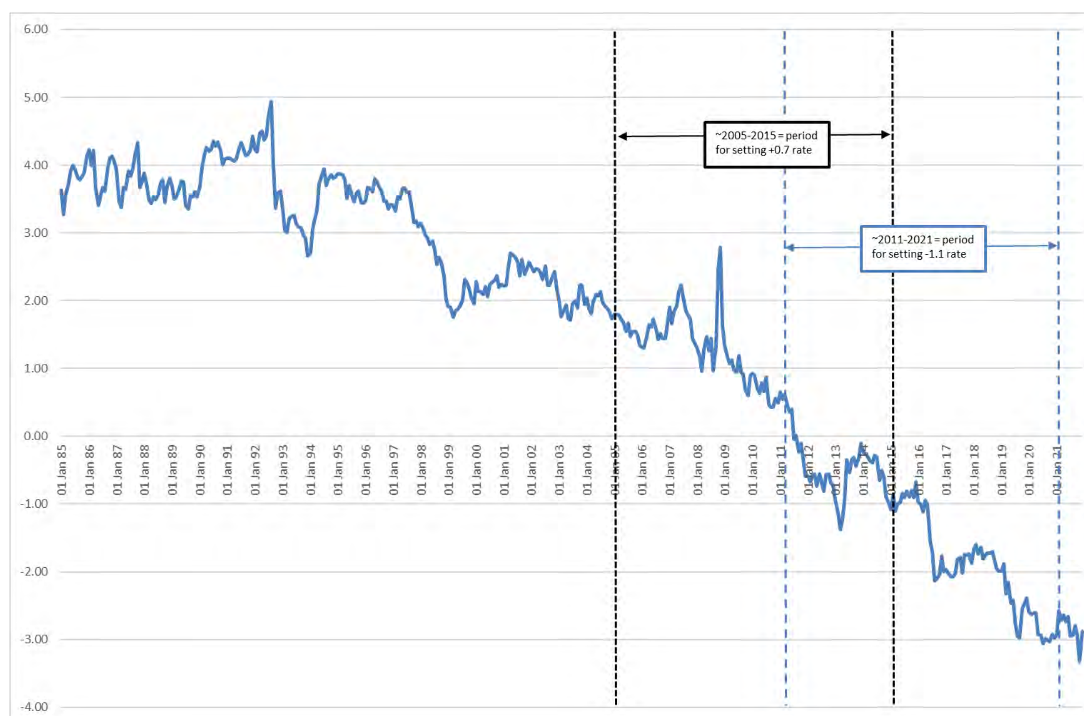
Chart 1: Bank of England implied real spot curves (10 year maturity)



How do we interpret this?

5. This is government accounting catching up with the market reality. It is currently much cheaper for government to borrow money than had been implied by a real discount rate of 0.7%.

6. From a government perspective, future repayments on student loans go towards offsetting the principle lent and the cost of borrowing money in order to lend it to students. If the cost of borrowing decreases a higher proportion of future repayments go towards repaying the loan principle. Therefore the estimated government subsidy as captured by the RAB and stock charge is lower.

7. The discount rate is not a forecast of the cost of government borrowing for loans issued in future years. The cost of borrowing may rise. Yields below inflation are a very recent occurrence, and it is not guaranteed these will continue. However the HMT policy to update the discount rate annually should reduce the likelihood of very large changes in rate.

What does it impact?

8. The changes to our RF RDEL metrics (RAB and carrying value). This doesn't change the fiscal cost of student loans (PSNB, PSND etc). It also doesn't change the realities of the proportion of students who repay their loans in full.

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Future considerations

9. Discount rates have previously been updated in line with SR timetables, but given the recent pattern of single year SRs, HMT now plans to update these annually going forward.

10. The other part of discounting is RPI – and we know that this has been on the rise over the last year – the March value is the key one for our forecasts. When RPI is updated at the Spring Statement this might offset some of the decrease in RAB charge.

11. RPI is likely to be replaced by CPIH from 2030. CPIH is around 0.9ppts lower than RPI. We are yet to make this change in our modelling as we align with the OBR who have indicated that they won't amend this until summer 2022 at the earliest. From 2030 the discount rate would then effectively be CPIH-0.2%.