uk2020

A supplement to Timebomb: How the university cartel is failing Britain's students

DEFUSING THE DEBT TIMEBOMB

A FAIR DEAL FOR STUDENTS AND THE TAXPAYER

By Richard Tice and Tariq Al-Humaidhi

Forewords by Lord Adonis and Owen Paterson MP

Author’s preface

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This report on the funding of student loans follows our release in early September 2017 of *Timebomb: How the university cartel is failing Britain’s students*. That gained considerable public attention and media coverage. The issues we highlighted – value for money and the importance of two-year courses to broadening choice – have attracted close attention from the government as it seeks solutions to provide a fairer deal for students.

Defusing the debt Timebomb: A fair deal for students and the taxpayer proposes some significant changes to the way loans work that will bring down costs for students and graduates, while also reducing losses for the taxpayer.

It also proposes a new financing mechanism, the National Student Bond, which would be attractive to long-term pension-fund investors by helping them reduce their actuarial deficits.

As the government looks for ways to offer substantially more hope and opportunity for students, I believe this report contains credible, innovative potential solutions.

I would like to thank Jack Grimston for his assistance in preparing this report.

To read this report and Timebomb online, go to www.uk2020.org.uk/timebomb

Foreword

Andrew Adonis
Chair, National Infrastructure Commission
Secretary of state for transport, 2009–10
Minister of state for education, 2005–08

It has become increasingly clear that the university merry-go-round of cartel fees and ever-increasing vice-chancellors' pay is doomed.

This cannot happen soon enough. For too long universities have had free rein to grab as much as they can from students, graduates and the taxpayer with precious little regard for the value they provide. They have refused to take any criticism seriously and ignored numerous opportunities to take matters into their own hands, cut fees and give students a much better deal.

It is frustrating that vice-chancellors have been so stubborn and that they have been indulged by government for so long. Their failure to act made it inevitable that the funding system would need to be extensively reviewed, as the Prime Minister has now promised will happen.

It will be vital in the coming months that all those of us who have been campaigning for improvement keep up the pressure so that this review goes far beyond tinkering round the edges. We will need to be alert to the efforts the powerful, well connected university lobby will make – both in public and in private – to water down or delay reform.

UK2020 has already had a powerful impact on the higher education debate. I welcome this innovative contribution to the range of options now emerging on funding and the rigour with which the report makes its case.

Whatever solutions are adopted, it is time for the institutional self-interest of vice-chancellors and their senior management teams to take second place to the interests of the whole of society.

Foreword

Owen Paterson MP
Founder and chairman, UK 2020
Secretary of state for environment, food and rural affairs, 2012–14
Secretary of state for Northern Ireland, 2010–12

In the few weeks since publication of the *Timebomb* report, we have seen the government beginning to listen to public concern and grapple directly with the problems of high student debt and poor value provided by universities.

The Prime Minister's acknowledgement that there are serious weaknesses in the current system is a welcome development. It means the debate can now move forward into exactly how to fix the problems and crack the higher education cartel.

If reforms to funding are to win public acceptance for the long term, it is vital they combine fairness to the student and graduate, value for the taxpayer and a spur to universities to improve. This report by the authors of *Timebomb* sets out a series of imaginative and realistic ideas that balance all these objectives. It goes further. The proposal for a National Student Bond that would both fund student loans and provide a secure return for pension funds could turn higher education funding into a real stimulus for business investment.

It is important that in the drive to reform, we do not discard the benefits that the system of tuition fees and loans has brought to universities over the past 20 years. This report, taken together with the authors' earlier recommendations, makes the most of those positive features while proposing fundamental change where it is needed.

The country needs to fund superb universities that are fit to take on the global competition in the decades ahead. This has to be achieved in a way that works for the whole of society. As the government searches for solutions, the ideas in this report will be central to shaping the debate.

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Introduction

The report we released in September – *Timebomb: How the university cartel is failing Britain's students* – detailed just how badly the higher education system is letting down undergraduates in the era of £9,000-plus tuition fees.

When charges nearly trebled in 2012, choice and teaching quality were supposed to improve in return. But universities and their ever-more highly paid vice-chancellors failed to deliver. Students are increasingly unhappy with the value for money their education gives them and established institutions have behaved like a cartel, all charging the same and stifling new competitors.

As a result, the current generation of students is heavily indebted, short-changed and justifiably angry.

Meanwhile, the taxpayer faces the risk of having to clean up a subprime crisis in student loans in future decades, writing off unknown hundreds of billions of pounds that will never be repaid.

In *Timebomb*, we put forward proposals for how universities and the government can improve value for money, centred on the rapid expansion of two-year degrees. We also set out broad principles that should underpin reform of the funding system, which has now become urgent.

It is welcome that the government appears to recognise swift action is needed. At the Conservative party conference in October, the Prime Minister announced a "major review of university funding and student finance". In the meantime, there will be short-term measures to ease the burden on students and graduates. The government has scrapped an inflation-linked fee rise planned for next year and will raise the threshold at which graduates start to repay. But these are only sticking-plaster fixes and it is vital the impetus for far-reaching change is maintained.

The new approach to funding we are proposing is ambitious and would provide a secure future for students, graduates, the taxpayer and universities as well as a stimulus for the wider economy.

It reduces student debt by scrapping all the interest charged on loans. The lost interest will be more than recouped for the taxpayer because the measures we are proposing will drastically reduce the problem of non-repayment, mainly by ending the automatic cancellation of debts after 30 years.

We also propose a pioneering scheme to fund student loans with a new financial instrument – the National Student Bond (NSB). Backed by government guarantees, it will be targeted at pension funds. The attractiveness of the bond, offering a higher interest rate than conventional gilts, will increase the valuation of funds, enabling companies to re-route money into jobs and growth rather than using it to fill widening deficits in their pension schemes.

Our proposals preserve and enhance the positive features of the current system. It is a sound and fair principle that students, who will go on to become the country's highest earners, repay most of the cost of their degrees rather than every taxpayer, the majority of whom have not been to university, having to cover it.

It is a fundamental requirement that we protect the needs-blind element of university education so loans cover the full cost of fees. Noone should be deterred from going to university by worries that they cannot afford to pay fees up-front.

The National Student Bond we are proposing would be an attractive product for investors that also provides a stable long-term source of funding for higher education.

The details of our proposals will need to be discussed extensively between the government, universities and fund managers who will buy the NSB.

Our goal in this report is to open the debate by outlining a new, fair funding deal that will benefit the whole country.

1. The scale of the challenge

Students and graduates

As student debt has ballooned since 2012, so alarm has heightened over its implications both for the individual and for government finances.

A decade ago, the average student left university with a debt of around £15,000 and by 2012 this had grown to £25,000 as fees rose. At that time, the Institute for Fiscal Studies (IFS) forecast average debts on graduation – including fee and maintenance loans and accumulated interest – at £47,000. In summer 2017, the IFS estimated that the figure had gone up again to £50,000 after maintenance grants to cover the living costs of students from low-income families were replaced with loans. That poorer group can now expect to graduate with £57,000 in debts. It is no wonder the IFS reports English students leave university with the world's highest debts.

More than 10% of debt consists of interest, which starts to compound as soon as students begin a course. The rate for this academic year – calculated as retail price inflation (RPI) from last March plus 3% – is 6.1%. Interest alone amounts to an average of £5,800 of debt on graduation, with the poorest 40% of students racking up the most – £6,500.[1] When the course ends, the interest rate falls back to RPI until they are earning £21,000, rising back up on a sliding scale to RPI plus 3% when income hits £41,000.

1 Higher education in England: Past, present and options for the future, Institute for Fiscal Studies, July 2017 www.ifs.org.uk/publications/9335

Rising debts lengthen the time graduates must keep repaying their loans until anything left is written off after 30 years. Their monthly payments, fixed at 9% above the £21,000 level, stay the same whatever happens to their headline debt total. The monthly figure is lower than under the pre-2012 system – a key selling point for the current set-up.

But even these monthly payments have not been immune from government tinkering. The threshold was supposed to go up in line with earnings, but ministers instead froze it, pushing up total repayments.

The IFS has calculated that only the best-paid 22.6% of graduates are ever likely to repay their loans including interest in full before they are cancelled. Overall, graduates are forecast to repay an average of £48,600 at 2017 prices over their lifetimes.

How much will graduates repay?*

STARTING SALARY	SALARY IN 30 YEARS (AT 2017 PRICES)	TOTAL REPAID (AT 2017 PRICES)	WILL DEBT BE CLEARED?
£10,000	£41,000 (£17,000)	Zero	No
£15,000	£62,000 (£27,000)	Zero	No
£20,000	£86,000 (£36,000)	£15,000 (£7,000)	No
£21,000	£90,000 (£37,000)	£21,000 (£11,000)	No
£25,000	£108,000 (£44,000)	£45,000 (£25,000)	No
£30,000	£130,000 (£53,000)	£75,000 (£43,000)	No
£35,000	£151,000 (£62,000)	£105,000 (£62,000)	No
£40,000	£157,000 (£71,000)	£135,000 (£80,000)	No
£45,000	£185,000 (£79,000)	£149,000 (£91,000)	Yes – after 29 years
£50,000	£205,000 (£88,000)	£125,000 (£85,000)	Yes – after 24 years

*Calculations by MoneySavingExpert.com. Figures based on students starting a degree in 2017 and beginning work in 2020 with a debt on graduation of £51,600. Retail price inflation is assumed to average 3% a year and graduate earnings to increase at RPI plus 2%. Interest increases debt annually by RPI plus 0.00015% for every pound above £21,000, reaching a maximum of RPI plus 3% at £41,000. Those thresholds are now due to be raised.

The cross-subsidy by which high earners pay back more to cover some of the debts written off for middle and low earners was designed into the system to make it more progressive. However, the danger is that conditions may become so weighted in that direction that well-off parents pay fees up-front or high earners clear all their debts as early as possible. If these groups shun the student loan scheme, its financial rationale crumbles.

Without change, debts will increase remorselessly. Up to now, the government has been reassuring universities they can expect annual fee rises in line with inflation if they pass official teaching assessments. Using a conservative forecast of 2% inflation, the current fee of £9,250 would reach £11,500 in a decade. Even many well paid doctors and engineers will be unable to repay in 30 years.

It is welcome that the rise planned for 2018/19 has been cancelled and that the cap will be frozen pending the government's funding review, originally promised in the Conservatives' 2017 election manifesto. It is important that the link between teaching quality and any future fee rise is maintained.

The taxpayer

One aim of the 2010–12 reforms was to make the system more affordable for the taxpayer. But the scale of lending and the near-impossibility of accurately forecasting repayments mean student funding has the potential to turn into a subprime crisis for future generations.

The 2012 fee rise quickly led to the face value of student loans more than doubling between 2011 and 2017 from £34.4bn to £89bn,[2] including more than £13.5bn of new loans advanced in 2015/16. These totals cover English students at institutions throughout the UK and EU students in England.

In 2014, the government forecast total debt would reach £1 trillion in cash terms by the late 2040s.[3] This was before a series of policy tweaks that will further add to the debt pile. They include the interest-rate and maintenance-loan policies described above as well as significant increases in the number of postgraduates, part-time undergraduates and students in further education colleges and private higher education colleges who are eligible for loans.

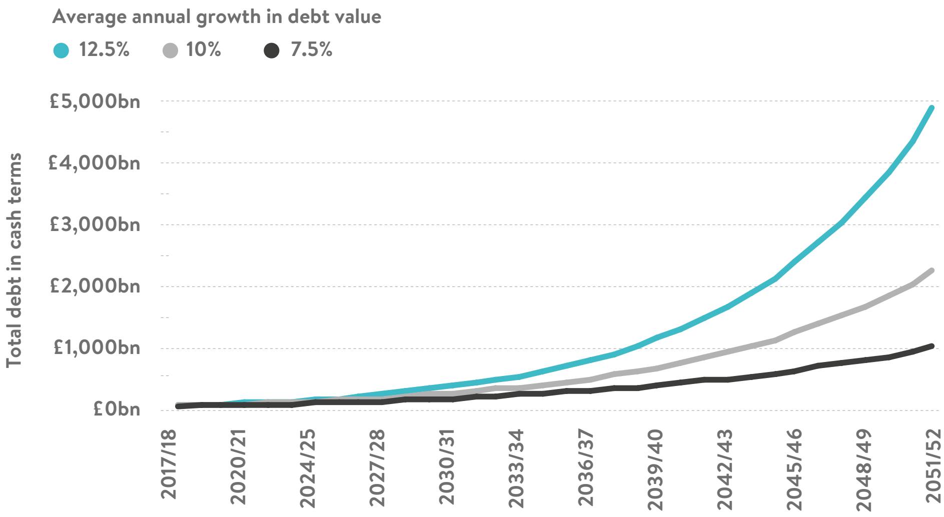
The trillion-pound moment could come even sooner. If the debt pile increases at an average of 12.5% – down from 17–19% as higher loans fed into the system from 2012 – the total would pass £1 trillion in 2038/39. At a more conservative 10%, this level would be passed in 2043/44 and at 7.5% a year, the date would be 2051/52.

2 Student Loans Company, Statistics on student loans debt and repayment, June 2017 www.slc.co.uk/official-statistics/student-loans-debt-and-repayment.aspx#

3 David Willetts, House of Commons, Hansard, June 18, 2014, columns 655–657 https://publications.parliament.uk/pa/cm201415/cmhansrd/cm140618/text/140618w0002.htm

How the debt pile will grow

Face value of outstanding student debts



Source: Authors' calculations

But forecasts such as these are speculative and have fluctuated widely even in the few years since fees went up.

As the government's own auditor, the National Audit Office, has warned, "managing student loans will become more challenging as the scale of the loans in issue increases" and "because of the unique nature of the student loan book, identifying its value is particularly complex".[4]

Forecasts have to take into account everything from future graduate earnings to inflation, student numbers, fee levels and the government's cost of borrowing. The figures are highly sensitive to any of the components changing and veer around even more when ministers change conditions for borrowers. The IFS has calculated that if graduate earnings growth is two percentage points lower than its central forecast the long-term cost to the taxpayer of the scheme increases by 48%.[5]

Forecasts are often proved wrong quickly. In 2011, the Office for Budget Responsibility (OBR) forecast average fees of £7,500. Like ministers, it had failed to predict the university cartel would jump altogether to the maximum allowed.

In 2011, the OBR forecast student loans would increase government net debt "by a maximum of 4.3% of GDP around the early 2030s, falling to 3.3% of GDP by 2060/61 as the value of loan repayments rises relative to the value of new loans

4 Evaluating the government's balance sheet: financial assets and investments, National Audit Office, June 2016, p4 www.nao.org.uk/wp-content/uploads/2016/06/Evaluating-the-government-balance-sheet-financial-assets-and-investments.pdf

5 Higher education in England; past present and options for the future, Institute for Fiscal Studies, July 2017, table 2.5 www.ifs.org.uk/publications/9335

made".[6] By 2017, it was predicting the impact to be greater and to last longer: "The net effect [of policy changes and new forecasts] has been to push the peak effect on net debt up to 11.1% of GDP in the late-2030s. By 2066/67, the addition to net debt is projected to fall back slightly to 9.3% of GDP."[7]

Forecasts about write-offs are even more uncertain and are obscured by highly complex accounting practices. The Department for Education (DfE) is required to make provision in its accounts for the amount of its loan outlay each year that will never be repaid. Over the past five years, this figure, the Resource Accounting and Budgeting (RAB) charge, has risen from 32% to 45%. It went back down to 28% following changes in the discount rate used to forecast the value of loans. The recent changes announced by the government will push the charge back above 40% without further reform.

The RAB charge is the only element of student loan financing that has to be provided for directly from departmental budgets. This has sharply reduced the impact on the government's deficit compared with the situation when the bulk of the money for teaching came in the form of grants paid from annual public spending.

This has come at the cost of an unknown future bill to the taxpayer. All we can say with any confidence, as a quick glance at the graph on page 10 shows, is that it will be in the hundreds of billions. By the mid-2020s, only six to eight years from now, it will become clear that there is no hope of collecting much of the money and there will be intense pressure on the government to begin write-offs before 2046, the current date when large-scale cancellations are due to start.

2. Time for a re-think

In 2016 and 2017, the debate over tuition fees and student funding has erupted to a level not seen since the bitter clashes of 2010–11.

Support for the system has been shaken by interest-rate rises and soaring debt. Universities' widespread refusal to accept criticism over fee levels, teaching quality or vice-chancellors' pay has only riled the public even more.

A poll by BMG for the Independent in August 2017 found just 18% of people supported current fee levels and 31% wanted fees abolished, while 68% wanted the interest on student loans scrapped.[8]

Politicians have capitalised on this discontent. Jeremy Corbyn put abolishing fees at the heart of Labour's successful appeal to younger voters in the 2017

6 Office for Budget Responsibility (OBR), Fiscal sustainability report, July 2011, p10 http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-july-2011/

7 OBR, Fiscal sustainability report, January 2017, p8 http://cdn.budgetresponsibility.org.uk/FSR_Jan17.pdf

8 Less than one in five support £9,000 tuition fees, BMG Research, August 14, 2017 www.bmgresearch.co.uk/independentbmg-poll-less-one-five-support-9000-tuition-fees/

election – along with a heavy hint that he would cancel a large part of existing student debt, although he retreated from this as soon as polling day was out of the way.

Even Conservative politicians who support the current system are alarmed at how much support it is costing them among students and graduates. The party's voters are dangerously concentrated among the over-50s, with only around one fifth of under-25s voting Tory in 2017.[9]

The time has gone when fiddling beneath the bonnet will sort out the discontent. Clear and radical changes are needed.

For all the disadvantages outlined above, however, we believe Labour's proposals to dismantle the whole fee system would be a disastrous lurch backwards. They would risk wrecking British higher education, which for all its faults is a prize national asset, second in the world only to the United States.

Flawed options: Abolishing fees

Scrapping fees has an attractive simplicity, but this is superficial. The cost would go far beyond the immediate £12.7bn hit to the government's annual deficit[10] from going back to using direct taxpayer spending to fund universities. The policy would throw away the advantages and potential of a properly functioning fee system and ignores why it was first introduced. Student choice would once again be curtailed and the opportunities for those from the lowest-income families would shrink.

The central reason Tony Blair's Labour government introduced fees was to free universities from the damage inflicted by direct Treasury control. As higher education expanded in the 1970s, 80s and 90s, governments rarely allowed spending to keep pace. The Dearing report in 1997 found that "public spending per student in higher education institutions has fallen by more than 40% since 1976".[11] Complaints of packed lecture theatres and dilapidated buildings multiplied.

Rewinding to this era would mean the Treasury had little option but to reintroduce restrictions on numbers to rein in spending or funding per student would decline precipitously.

In *Timebomb*, we noted that removing number controls has been one of the greatest advances for student choice since 2010, even though in other areas the government has failed to open the system to the full benefits of competition. Since 2015/16, universities have been free to recruit as many undergraduates as they can attract rather than having places centrally allocated. This has

9 See for example How Britain voted at the 2017 general election, YouGov, June 2017, https://yougov.co.uk/news/2017/06/13/how-britain-voted-2017-general-election/

10 Labour's higher education proposals, IFS, May 11, 2017 www.ifs.org.uk/publications/9217

11 The Dearing report: Higher education in the learning society, 1997, p45 www.educationengland.org.uk/documents/dearing1997/dearing1997.html

enabled many leading institutions to expand, putting pressure on those lower down the league tables to improve and diversify.

Abolishing fees and loans would remove this choice at a stroke.

Abolition alone would also be unfair on those who have already accumulated high student debts. They would justifiably demand equally generous write-offs, which would amount to tens of billions of pounds.

Those who would suffer most would be from the lowest-income families. The 2012 fee increase was followed by record numbers of 18-year-olds in England going to university, contrary to what many experts predicted. Those from the poorest backgrounds are now 80% more likely to go into higher education than they were a decade ago. There is still far more to be done before they catch up with their wealthier contemporaries. But the gap is significantly narrower than in Scotland, where undergraduates do not pay fees and spending and places are controlled centrally. This has reduced the incentive for universities to seek out students beyond their traditional middle-class clientele.[12]

Flawed options: Graduate tax

A variation of abolishing fees is to add a graduates-only supplement to income tax. Like using general taxation, this option has the attraction of getting rid of the politically poisonous headline fee figure. The difference is that a graduate tax does not require all taxpayers to foot the bill for teaching undergraduates who will go on to become the country's highest earners.

Sir Vince Cable, the Liberal Democrat leader, said this autumn he was looking at graduate tax as one option for his party's higher education policy. Seven years ago, Cable, who as business secretary in the coalition government oversaw the increase in fees, called graduate taxation "simply unworkable".[13]

The policy suffers from many of the same drawbacks as funding from general taxation. Lord Browne, whose 2010 report for the coalition recommended increasing fees, carefully considered graduate taxation and rejected it, arguing that it "weakens institutional autonomy as well as the role of student choice".

Another difficulty, particularly near election time, would be ensuring the full revenue of a graduate tax went to universities rather than being diverted to priority areas such as the NHS and schools.

12 See for example Access in Scotland, Sutton Trust, May 2016, www.suttontrust.com/wp-content/uploads/2016/05/Access-in-Scotland_May2016.pdf

13 Vince Cable, House of Commons, December 9, 2010, Hansard column 541 https://publications.parliament.uk/pa/cm201011/cmhansrd/cm101209/debtext/101209-0002.htm

Flawed options: Tactical retreat

Other ideas include cutting fees back to £3,000, supplemented by increased Treasury spending, while also reducing interest rates. This would avoid the worst effects of abolition, but still dilute the effect of student choice and lessen the pressure on universities to improve.

A further drawback is that the main beneficiaries would be the minority of graduates on the highest incomes who earn enough to clear all loans well within 30 years. Those whose debts are written off already would see far less improvement.

The government's decision to raise the £21,000 repayment threshold to £25,000 is welcome and will bring a saving of around £360 a year to graduates. However, like cuts to interest rates, it only makes sense as part of a more ambitious set of reforms. By itself, it will cost the taxpayer more in lost repayments. It will also do nothing to help those who went to university before 2012 who, although they have lower overall debts, have to make higher monthly repayments than later cohorts. According to the consultancy London Economics, the changes push the RAB charge up to 44.6% and increase the proportion of students who will never repay in full from 72% to 81%.

3. A new offer for students and the country

The changes we propose would fix some of the worst problems while building on the best features of the current system, which has led to record numbers of people going to university.

These features include:

- A clear commitment to provide loans so no student has to pay fees up-front. They should only be required to repay when they are earning a good salary.
- The principle that student choice drives improvement in standards. Universities and new private colleges should be competing on quality and price.

The system we are proposing rests on two pillars: a fair deal for students and a National Student Bond to improve value for the taxpayer. The bond would have the added benefit of freeing up private capital from pension funds to invest in the wider economy – money they are currently using to plug yawning deficits in their schemes.

A fair deal for students

The government should make a bold offer that takes away some of the burden of loans for students and graduates while also reducing uncertainty for the taxpayer.

Interest on loans should not just be cut, it should be removed entirely. That means cancelling all interest currently owed and reducing rates to zero for future loans. Repayments would only cover the capital value of the original loans.

Currently, interest piles up faster than many graduates can repay and in the end will mostly be written off, along with much of the capital value. The current system disproportionately hits those from low-income families who take out maximum maintenance loans and then see the interest on them compound year after year.

Interest could be cancelled in full now at no extra cost to the taxpayer.

The face value of student loans in England at the end of March 2017 was £89bn, which would be brought down to £78bn by cancelling the £11bn of accrued interest in the total. This would still leave a residue significantly higher than the £61bn carrying value the government currently assigns to the loan book, which reflects the forecast of how much will be repaid, a calculation that uses complex economic models adjusted by government accounting rules. The valuation shows that even after writing off the loan interest, there are provisions in place covering a further £17bn, nearly 30% of the carrying value.

In addition to lowering debts by removing interest, it would be possible to reduce graduates' outgoings by uprating the earnings level at which payments start, cutting the 9% repayment rate or a combination of both.

What graduates would repay

Figures are based on repaying principal of £45,000 under our proposed scheme charging zero interest*

At 9% a year of earnings above £21,000 (current rate)

SALARY	ANNUAL REPAYMENT	YEARS TO REPAY
£30,000	£810	>50
£35,000	£1,260	36
£40,000	£1,710	26
£50,000	£2,610	17

At 9% above £25,000

SALARY	ANNUAL REPAYMENT	YEARS TO REPAY
£30,000	£450	>50
£35,000	£900	50
£40,000	£1,350	33
£50,000	£2,250	20

At 7% above £25,000

SALARY	ANNUAL REPAYMENT	YEARS TO REPAY
£30,000	£350	>50
£35,000	£700	>50
£40,000	£1,050	43
£50,000	£1,750	26

*Earnings are career average at 2017 prices. Thresholds maintained at 2017 prices. Years are rounded, with periods above 50 years not specified.
Source: Authors' calculations

In addition to these adjustments, graduates should be protected from ministers changing loan conditions retrospectively when they want to increase income. At the moment, students can have little confidence about what they will actually be required to repay in the future. One option for greater certainty could be to extend consumer credit protection to student loans. If necessary, the scheme's conditions could still be amended to protect the taxpayer's interests, but only for new borrowers.

One of the most important changes under the scheme would be to abandon the current guarantee to write off remaining debts after 30 years. Except for special cases such as long-term disability, they would have to be paid back in full. But as the initial debt would be lower and inflation would erode its real value, the burden on graduates would be reduced.

Under the current system, a graduate who goes straight into a job paying over £21,000 can expect to have any remaining debts written off when they reach their early 50s, when many will be at peak earning power. The pension age is due to increase to 68 for anyone born after March 6, 1978, giving graduates under our scheme another 15 earning years to pay off their loans. If income falls below the repayment threshold, for example when they retire, then their repayments would stop as happens now.

The government should consider other changes that, in return for lower debts and monthly payments, would improve recovery rates and reduce losses for the taxpayer.

These could include:

- Discounts for graduates who pay off in full early, for example 8% for doing so in the first decade after graduation, falling by 2% per decade after that.

- Allowing students' parents or grandparents to pay off loans to reduce inheritance tax liabilities, either in their last seven years of life or in their wills. This would encourage sensible estate planning and give middle-class families a real incentive to clear debts.

- Some may argue that pushing repayments to the maximum should include claiming any outstanding balance from a graduate's estate when they die, though this is likely to prove too politically controversial.
- Requiring graduates working overseas or EU students who have returned home to make fixed monthly repayments. This group are notoriously hard to secure accurate salary figures and payments from. Defaulters could be barred from entering the UK or served with enforcement notices on arrival. A similarly tough approach in New Zealand had an immediate positive effect on repayments.
- Universities should be required to pay the interest to holders of NSBs or cover a significant proportion of non-repayment by their graduates. Incentives such as these would make them think hard about fee levels and value for money. They would also encourage universities to keep in touch with their alumni to help ensure repayment. At the moment, there is nothing to deter universities from setting prices at the maximum.

It would be realistic to expect recovery rates to improve to more than 80% under our plans, compensating for the effect of inflation eroding the value of debts. Instead of a student subprime crisis erupting in the 2020s, the taxpayer will be spared from writing off hundreds of billions of pounds.

The new system will also boost the power of student choice to drive improvement in value for money. Unlike now, the headline debt figure would represent the actual amount students will be required to repay. This will give them a clear incentive to seek out best value and push universities to respond to demand. If graduates from a particular course are unlikely to go on to high-earning jobs, institutions will be under pressure to improve teaching and set fair prices. The availability of earnings data for individual subjects at each university that we described in *Timebomb* will make informed choice easier.

The proposed scheme will also add to the incentive for students to choose alternatives to the traditional three-year degree, which the current funding system pushes them into. More are likely to opt for the two-year courses we advocate in our original report, which would bring lower debts as well as more intensive teaching. Because of the shorter time available to earn in the holidays during a two-year degree, there could be a case for reintroducing targeted maintenance grants for low-income students to encourage them to choose these courses.

The new scheme, together with the proposals in *Timebomb*, would also encourage greater numbers to opt for other forms of degree such as part-time or distance learning courses.

How debts of two and three-year degrees compare*

	TWO YEARS	THREE YEARS
Tuition	£25,199	£28,449
Maintenance	£11,624	£17,654
Total	£36,823	£46,103

*Based on interest-free full loans for annual tuition fee of £9,250 for three-year degree starting in 2017 and £12,444 for two-year degree, which is 2017/18 fee for two-year course at University of Buckingham. Maintenance based on typical annual loan of £5,740. All loans uprated by 2.5% per year.
Source: Authors' calculations

Given universities' behaviour until now in simultaneously raising fees to the maximum, the £9,250 cap for 2017/18 should only be raised in the future for institutions that fulfil strict criteria for providing high-quality education under the government's Teaching Excellence Framework, which is currently being phased in. If fees remain frozen, then universities should have the maximum they can charge cut if they fail these tests. Those that offer accelerated two-year degrees – or three years for courses usually studied in four – could also be given financial incentives and preference.

The Prime Minister has acknowledged there is too little choice for students, highlighting uniform fee levels and the lack of two-year degrees.[14] As an extra spur to universities, the government could also impose different fee caps for different subjects. This would particularly help students on arts and humanities courses, who are often charged thousands of pounds more per year than the cost of teaching their degree.

While we have concentrated on undergraduates on full-time degrees, who are the largest group of borrowers, our proposals would also help increase choice for the growing numbers of postgraduates, part-time undergraduates and students on further education courses who will be taking out loans in the future.

The National Student Bond

The second pillar of our proposed system is a new way to fund student loans. It would benefit the taxpayer while easing the deficit crisis in Britain's pension funds, which would have the added advantage of freeing up capital for businesses to invest in the economy.

It could potentially allow student funding to be removed from the government's balance sheet altogether, providing better value and protection to the taxpayer.

The National Student Bond would be issued annually by an overhauled Student Loans Company (SLC), the government-owned body that lends to students and manages repayments. The bond would offer an attractive long-term

14 Theresa May's tuition fees revolution to win over students, the Sunday Telegraph, October 1, 2017 www.telegraph.co.uk/news/2017/09/30/theresa-mays-tuition-fees-revolution-win-students/

investment targeted at pension funds. It has the potential to become a whole new asset class for the industry. This would be a win-win that would help pension savers without increasing the amounts charged to student borrowers, who under our proposals would pay the SLC no interest.

The exact conditions of the bond should be subject to consultation with the pension fund industry, but key features should include:

- The term of the NSB should be 30–40 years as an incentive to long-term investment that also reflects the typical life of a graduate loan under our proposals.
- The NSB should pay a coupon interest rate 0.5%–1% above equivalent government gilt-edged bonds to increase its attractiveness. Currently, the 30-year gilt pays in the region of 1.5%, which would mean the NSB paying investors around 2%–2.5%.
- The interest would either be paid by the government or preferably by the universities themselves. This would encourage them to be more efficient with the funds they receive, offer better-value courses and administer the public's money more effectively than now, with the abuses widely seen such as inflated pay for vice-chancellors. It could bring the added advantage of enabling the NSB to be taken off the government books, significantly strengthening public finances.
- NSBs would be asset-backed by student repayments and an unlimited government overdraft to the SLC, which would cover any risk of losses and reassure investors.
- The bond would not be tradeable on the open market, though investors would be able to sell it back to the SLC at a small discount. This will encourage the right type of long-term pension-fund investment and close out short-term speculators.
- Investors could be provided with further reassurance by making the NSB an amortising bond, meaning the SLC repays a percentage of the principal each year in addition to interest.

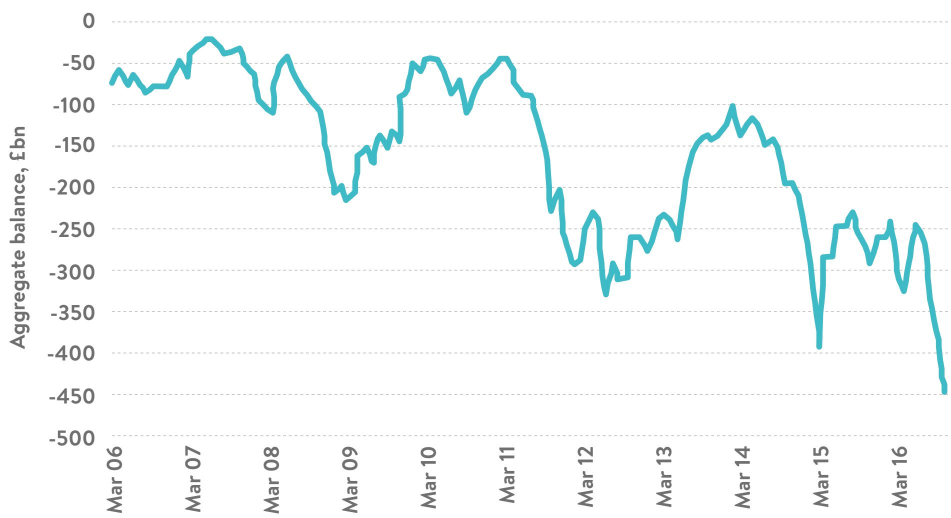
Paying 2.5% to NSB bondholders on a £12bn annual tranche of student loans would cost the government £300m, around £120m more per annum than the cost of borrowing on the gilt markets. However, this would be covered by stronger graduate repayments and would also achieve far greater value through its wider effects on the economy.

The NSB's higher rates of return over the long term than conventional gilts and its backing by either an implicit or explicit government guarantee would enable pension funds to increase their actuarial valuations. This would reduce their deficits, cutting the annual amount companies and employers pay in to top up their schemes and freeing up money every year to invest in growth and jobs.

The pension funds the NSB will target are a significant drain on business investment. The combined deficit of around 5,800 defined benefit schemes in the UK stood at £420bn in August 2017.[15] In 2016, FTSE 100 companies made £17.3bn of contributions to their schemes, the highest amount ever.[16] By far the biggest deficit of all private pension funds is in the Universities Superannuation Scheme (USS), which provides for retired academics and other staff mainly from pre-1992 universities. In March 2017, the gap between the USS's assets and liabilities stood at £17.5bn on assets of £60bn. This is almost double the next-largest deficit on any scheme in the UK, which is BT's £9.2bn. Taxpayers may be surprised to find out that last year, 13 people running the USS were earning more than £500,000 a year – up from three in the previous year – and two were on over £1m.

The scale of the USS deficit puts teaching at risk as universities have to pay in more to plug the deficit. The scheme could, however, become the biggest investor in the NSB. Buying student bonds would reduce the USS's deficit, freeing up money for universities and enabling them to reduce fees and invest in teaching.

The growing pensions deficit*



*Figures are assets minus liabilities for all defined benefit schemes in deficit
Source: Pension Protection Fund Purple Book 2016 www.pensionprotectionfund.org.uk/Documents/Purple_Book_2016.pdf

15 Pension fund deficit falls to £420bn, PWC Skyval Index, August 2017 www.pwc.co.uk/press-room/press-releases/UK-pension-deficit-falls-to-420bn-according-to-PwCs-Skyval-Index.html
16 Accounting for Pensions 2017, Lane Clark and Peacock https://insight.lcp.uk.com/acton/attachment/20628/f-05f8/1/-/-/-/-/Accounting%20for%20Pensions%202017.pdf

The NSB would go far beyond previous attempts to tap the markets to fund student debt. Unlike our proposal to fund loans up-front by issuing bonds, the government's approach has been to package and securitise existing loans. In February 2017, ministers announced the biggest issue so far, covering around £4bn of loans made to some 450,000 students who began repaying between 2002 and 2006. Until now, market interest has been limited. These securitised packages are subject to more commercial and political risk than would be the case with the long-term annual NSB, which will directly support the education of the country's university students.

The NSB would be the biggest programme of its kind in the world and require significant improvement and expansion of the SLC. But a scheme with many similarities has been successfully adopted in Hungary. Since 2001, the country has offered loans to all students, with repayments dependent on income. It was set up with the help of the SLC in the UK and two British academics – Professor Nicholas Barr of the London School of Economics and the late Iain Crawford.

The scheme covers loans through bond issues offering investors a premium of around 2.5% over standard government bonds, which covers the risk of non-repayment and an administration charge. The collection rate is around 98%.[17]

The loans are not included in public borrowing because enough of the risk has been transferred to the private sector to satisfy International Monetary Fund and European Union rules on government accounting.

Although the Hungarian scheme is not fully comparable with what we are proposing, partly because it only covers a minority of students' requirements, it could provide valuable lessons.

Conclusion

Uncertainty over the future of higher education is opening up a wealth of opportunities for positive change.

The current funding system risks turning into a mess that is landing the younger generation with excessive debts and future taxpayers with multi-billion pound write-offs. Reform has become urgent.

The fair deal we are proposing reduces the burden on students and graduates and creates a more stable system that benefits taxpayers as well as borrowers.

17 Scheme described in The funding challenge for universities, Universities UK, 2014, p27–28 www.universitiesuk.ac.uk/policy-and-analysis/reports/Documents/2013/funding-challenge-for-universities.pdf

Student loans need not be viewed just as a drain. They can be harnessed to economic strategy and mobilised to create a valuable new source of stimulus for business.

The reforms proposed in our previous report together with the new funding system described here can break the university cartel while helping institutions to reach their full potential and prosper in the face of ever-stronger global competition.

They are the way to defuse the debt Timebomb under British higher education.

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