The Treasury

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[1] 6(a) - to prevent prejudice to the security or defence of New Zealand or the international relations of the government

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Date: 18 January 2012

To: Minister of Finance

Aide Memoire: Savings Associated with Adding 2% Interest to Student Loans

Purpose

This note provides you with Treasury's initial estimate of the savings that could be achieved by adding 2% interest to student loans. It is intended to inform your thinking in the lead up to Budget 2012.

Background

Student loans have been interest free for borrowers working in New Zealand since 2005. By reintroducing some level of interest for domestically domiciled borrowers, we would expect to see two main effects:

i. Borrowers face better incentives to borrow only as much as they need or to access finance through other means, and to repay more quickly, and

ii. The value to the Crown of the lending is increased as currently the Crown writes off 45 cents in every dollar lent through the scheme. Of this 45 cents that is written off, 73% is due to the lack of interest (see Annex 1 for further information).

Costings and Assumptions

To develop the costings included below, we have built a model based on the forecasts from Treasury's Fiscal Strategy Model. Student Loans agencies (the Ministry of Education, Inland Revenue and Statistics New Zealand in particular) have much richer data available, so ***these costings below should be considered as preliminary and indicative only***. To develop more accurate costings we would need to either access the information held by student loans agencies or have them run particular scenarios on our behalf. We can investigate this further, if you would like us to do so.

In both scenarios below, we have assumed that interest would apply to both new lending and existing loans. We have therefore modelled the effect of adding 2% interest on the existing portfolio of loans, as well as to all new loans. The savings would be significantly lower if interest were to be applied to only new loans.

Scenario 1

The main assumptions associated with this scenario are as follows:

- Borrower numbers: new borrowers decrease by 2% relative to estimates based on growth in eligible borrowers. We have been relatively conservative in adjusting this as we think that although interest will create some disincentive for people to borrow, at such a low rate the effect may not be significant.

- Initial write-down: we have assumed that this would increase to 58 cents in every dollar. We have roughly based this number on information we have from the

Ministry of Education around the effect of applying full interest on student loans – it represents a conservative third of the effect of full interest.

- Average borrowed during the year: this has been retained at the same rate, as we have modelled the behavioural effect through the change in borrower numbers.
- Average repayments: this has been retained at the same rate. Repayments under current policy are made on a flat rate basis (10 cents in the dollar). So increasing the interest rate does not immediately impact on compulsory repayments. The behavioural effect only eventuates as interest accrues and borrowers balances become commensurately higher therefore increasing the amount of time for repayment. As compulsory repayments make up the vast bulk of total repayments made, and because there is not enough evidence on the effect interest would have on voluntary repayments, average repayments have been held constant. We have therefore modelled the behavioural effect as a longer repayment period, instead of increasing repayments.
- Interest charge for the year: this is added on to the value of the student loans book each year to reflect the increase in the portfolio.
- Increased value of the loan book: based on Ministry of Education estimates made during BEFU 2011, we have assumed that adding 2% interest will increase the carrying value[1] of the loan book in the first year by 7%.

Results (note that all results are quoted to the nearest $100 million):

Impact	11/12	12/13	13/14	14/15	15/16	Total[2]
Capital available for reallocation	0	0	0	0	0	100
Operating savings/change in OBEGAL compared to PREFU	600	100	100	100	100	900

Capital available for reallocation is affected by changes in repayments and changes in new lending. A 2% decrease in the number of borrowers does result in less lending, but the estimate is for < $50 million improvement in each year of the forecast horizon. The overall change is represented in the total figure in the above table.

Operating savings/OBEGAL is mainly affected by changes to the initial fair value write-down. There is also a one-off $500 million increase due to the revaluation of the loan book during the year interest is first applied.

Scenario 2

The main assumptions associated with this costing which differ from those above are as follows:

- Borrower numbers: in this scenario we have weighted the decrease in borrowers more significantly towards the course-related costs and living costs elements of student loans borrowing, as we believe this is where student are more likely to reduce their borrowing (as opposed to fees).

1 The carrying value is the value of the Student Loan Scheme asset which is maintained in the scheme's accounts. It increases during the year as new loans are issued and decreases as repayments are made. Adjustments are made each year following an annual valuation of the asset.

2 Total may not equal sum of components due to rounding.

Results (note that all results are quoted to the nearest $100 million):

Impact	11/12	12/13	13/14	14/15	15/16	Total[3]
Capital available for reallocation	100	100	100	100	100	500
Operating savings/change in OBEGAL compared to PREFU	600	100	100	100	100	1100

Capital available for reallocation is higher due to the weighted reduction of new borrowers reducing new lending more relative to Scenario 1. Aggregate repayments decrease slightly towards the end of the forecast period due to fewer borrowers taking up loans from 2011/12.

Operating savings/OBEGAL is still significantly affected by the one-off $500 million revaluation in 2011/12, and in the forecast years has lower initial fair value write-down due to less new lending. The weighted reduction in borrower numbers has flowed through to a stronger operating savings/OBEGAL track across the forecast period, primarily through a lower initial fair value write-down.

Caveats

As previously indicated, ***we consider these costings to be very preliminary and they should be taken as indicative only***. Treasury does not have either the data or the experience in modelling student loans that student loans agencies would be able to provide. Therefore we suggest that, if there is further interest in this area, then student loans agencies be asked to prepare costings.

We would expect voluntary repayment levels to increase where interest is charged, as interest creates a greater incentive to pay off debt more quickly. However we only have two years of data on voluntary repayments, which is not enough to be able to model any changes on. Therefore we have not included this in our costings.

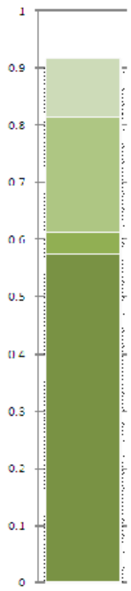
The effects on capital available for reallocation indicated above are likely to be underestimated as the model does not include voluntary repayments, where an increase in voluntary repayments would lead to a corresponding increase in capital available. When the voluntary repayment bonus was first implemented in 2009/10, there was $124 million of voluntary repayments, which attracted a corresponding $12 million bonus. In 2010/11 the corresponding totals were $86 million and $8.6 million respectively, and the estimates for 2011/12 are $20 million and $2 million respectively. With total repayments $1.3-$1.5 billion, it is possible that voluntary repayments could be a significant factor for capital available for reallocation.

[3]

Nic Blakeley, Manager, Education and Skills, Growth and Public Services, [3]

3 Total may not equal sum of components due to rounding.

Annex 1 - Cost of student loans lending - average value of each component[4]



Low lifetime earnings, death and bankruptcy write-offs	8.5 cents
Time value of money/8.25% Crown discount rate	10.8 cents
Risk-adjusted time value (at 6.7%)	22.05 cents
Full compliance	3.9 cents
Current value	54.75 cents

Source: Ministry of Education

4 This view uses the modelling assumptions used as the basis for costing Budget 2011 initiatives (including a discount rate of 8.25%).