The Treasury

Budget 2013 Information Release

Release Document

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[2] 6(c) - to prevent prejudice to the maintenance of the law, including the prevention, investigation, and detection of offences, and the right to a fair trial

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[12] Not in scope

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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.

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Further advice on the changes to calculating the cost of lending in the Student Loan Scheme and implications for the Tertiary Education Budget Package

Date:	21 March 2013	**Report No:**	T2013/709

Action Sought

	Action Sought	**Deadline**
Minister of Finance (Hon Bill English)	**Read and discuss** this report with the Minister for Tertiary Education, Skills and Employment. **Indicate** your preference for treating the savings from changes to calculating the cost of lending in the Student Loan Scheme.	9am, Friday 22 March 2013.
Minister for Tertiary Education, Skills and Employment (Hon Steven Joyce)	**Read and discuss** this report with the Minister of Finance.	9am, Friday 22 March 2013.

Contact for Telephone Discussion (if required)

Name	**Position**	**Telephone**		**1st Contact**
[3]				✓
Ben McBride	Team Leader, Labour Market & Welfare	04 917 6184 (wk)	[3]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Enclosure: No

Treasury Report: Further advice on the changes to calculating the cost of lending in the Student Loan Scheme and implications for the Tertiary Education Budget Package

Executive Summary

Joint Ministers agreed to changes in the calculation of the cost of lending in the Student Loan Scheme in October 2012. Subsequently, Audit NZ has approved this change, which means that it must be included in student loan reporting as soon as possible, that is from 1 January 2013.

A decision is being sought on whether to include the savings generated by these changes in the Budget 2013 package for tertiary education or return the savings to the centre.

Recommended Action

We recommend that you:

a. **note** that in Treasury's view and consistent with CO (11) 6, the savings of $102.000 million over the forecast period generated by changes to the cost of lending in the Student Loan Scheme are technical in nature and therefore should be returned to the centre

b. **note** that the Ministry of Education's view is that the tertiary education allocation in Budget 2013 should receive recognition of the savings made from the changes

c. **note** that subject to Ministers' decisions on spending initiatives, there may be a balanced Budget Package without the inclusion of these savings in the package

d. **note** that Ministers may wish to recognise that the centre has benefited from changes to the calculation of the cost of lending in the Student Loan Scheme, and agree to an increase in the baseline for Vote Tertiary Education from the operating allowance to fund additional spending initiatives

e. **indicate** the preferred option to propose to Budget Ministers for treating the OBEGAL impact from changes to calculating the cost of lending and recognition for Vote Tertiary Education of savings:

    a) return the savings from changes to the calculation of the cost of lending in the Student Loan Scheme to the centre (Treasury recommended)

    Agree/disagree.

b) maintain the savings in the tertiary education allocation based on their current profile, as below:

	Operating impact ($ million)					
	2012/13	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**5 year total**
Changing calculation of cost of lending for the loan scheme	(41.900)	(33.900)	(18.000)	(7.400)	(0.800)	**(102.000)**

Agree/disagree.

c) return the savings to the centre and provide an allocation to Vote Tertiary Education that reflects the average impact over 10 years of these savings:

	Operating impact ($ million)					
	2012/13	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**5 year total**
Changing calculation of cost of lending for the loan scheme	(10.200)	(10.200)	(10.200)	(10.200)	(10.200)	**(51.000)**

Agree/disagree.

d) return the savings to the centre and provide an allocation to Vote Tertiary Education that reflects the additional costs of preferred spending initiatives of the Minister for Tertiary Education, Skills and Employment, but no more than the average spread of the savings over the current forecast period:

	Operating impact ($ million)					
	2012/13	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**5 year total**
Changing calculation of cost of lending for the loan scheme	(20.400)	(20.400)	(20.400)	(20.400)	(20.400)	**(102.000)**

Agree/disagree.

f. **discuss** this report with the Minister for Tertiary Education, Skills and Employment before 9am on Friday 22 March 2013

Ben McBride
Team Leader, Labour Market & Welfare

Hon Bill English
Minister of Finance

Treasury Report: Further advice on the changes to calculating the cost of lending in the Student Loan Scheme and implications for the Tertiary Education Budget Package

Purpose of Report

1. This report provides you with further information on changes to the calculation of the cost of lending and the Tertiary Education Budget package for your considerations so the package can be finalised by Friday 22 March. Minister Joyce is planning to submit two Budget 2013 Cabinet Papers on Monday 25 March for SOC on 27 March.
2. A decision is being sought on whether to include the savings generated by the changes to the calculation of the cost of lending in the Student Loan Scheme in the Budget 2013 package for tertiary education or return the savings to the centre.

Ministers agreed, and Audit NZ approved, a change to the calculation of the cost of lending to improve the accuracy of the Student Loan Scheme

3. Joint Ministers agreed to changes in the calculation of the cost of lending in the Student Loan Scheme in October 2012. Subsequently, Audit NZ has approved this change, which means that it must be included in student loan reporting as soon as possible, that is from 1 January 2013.

4. The Effective Interest Rate (EIR) will be 'attached' to *each tranche of lending by year* as opposed to each *tranche of first time borrowers*. This means that the EIR for new lending in each year will be calculated using the current market risk free rate and the market risk premium at the beginning of that year of lending.

5. The new approach to calculating the cost of lending allows a more accurate fiscal forecast for the scheme and is a better proxy for the true cost. This will allow better decision-making in the tertiary education portfolio and lead to an improved allocation of resources.

The change also risks increasing volatility

6. Changing to a year-of-lending basis carries the risk of greater sensitivity to changes in interest rates, because changes will be reflected in the cost of lending on an annual basis rather than being spread over a number of years.

7. Table 1 below outlines the possible effects of changes in interest rates on OBEGAL (refer to Aide Memoire - T2012/2354). Interest rates and the impact on OBEGAL have a negative correlation, e.g. if interest rates increase over the forecast period, the savings and the OBEGAL impact decrease.

Table 1: Estimated savings from moving to the year of lending method under six scenarios

Note: OBEGAL impact based on implementation date of 1 July 2012. Auditors have decided the changes would be implemented on 1 January 2013 which reduced the total four year impact from $117 million to $102 million.

			2012/13	2013/14	2014/15	2015/16
1	Current interest forecast	EIR Year of lending method - %	**6.26%**	**6.26%**	**6.26%**	**6.26%**
		Saving in appropriations - Vote Revenue $m	67	46	29	17
		OBEGAL impact $m	64	36	15	1
2	One-off 1 % increase	EIR Year of lending method - %	**6.26%**	**7.26%**	**6.26%**	**6.26%**
		Saving in appropriations - Vote Revenue $m	67	(1)	42	26
		OBEGAL impact $m	64	(8)	32	12
3	Ongoing 1% increase	EIR Year of lending method - %	**6.26%**	**7.26%**	**7.26%**	**7.26%**
		Saving in appropriations - Vote Revenue $m	67	(1)	(4)	(8)
		OBEGAL impact $m	64	(8)	(12)	(16)
4	One-off 1 % decrease	EIR Year of lending method - %	**6.26%**	**5.26%**	**6.26%**	**6.26%**
		Saving in appropriations - Vote Revenue $m	67	98	16	8
		OBEGAL impact $m	64	86	(2)	(11)
5	Ongoing 1% decrease	EIR Year of lending method - %	**6.26%**	**5.26%**	**5.26%**	**5.26%**
		Saving in appropriations - Vote Revenue $m	67	98	67	46
		OBEGAL impact $m	64	86	47	21
6	Increase of 1% then a further 1% increase (sustained)	EIR Year of lending method - %	**6.26%**	**7.26%**	**8.26%**	**8.26%**
		Saving in appropriations - Vote Revenue $m	67	(1)	(46)	(38)
		OBEGAL impact $m	64	(8)	(52)	(42)

Source: Ministry of Education

The Ministry of Education notes that:

- a one-off interest rate increase of 1 percentage point would lead to a one year higher cost of lending under the year of lending method, compared with the borrower method, followed by a large reduction in the cost, relative to the former method; and

- a one-off fall in the interest rate of 1 percentage point would lead to a very significant drop in the cost of lending relative to the former method, followed by a small increase in the cost of lending.

Treatment of the Effective Interest Rate Changes

8. There have been discussions between officials over whether the changes should be regarded as technical in nature and therefore recognised in the March Baseline Update (Treasury's view) or are changes of a substantive nature whose treatment needs to be decided by Cabinet (Ministry of Education's view). The Ministry of Education also argues that the savings should be counted as part of the Budget 2013 package for tertiary education.

9. When the Student Loan Scheme was first valued under the New Zealand equivalent of the IFRS in 2006, an agreement was made by accounting specialists from PriceWaterhouseCoopers (PWC), Treasury and the scheme auditors to associate the EIR with a borrower's loan *account*, based on the borrower's time of *first borrowing*. This decision departed from the strict principles of IFRS. Technically, each tranche of lending made over a year should have an EIR associated with it that reflects the conditions applying when that tranche of lending was undertaken.

10. The decision for a borrower-based approach was made for pragmatic reasons. Applying the strict letter of the IFRS principle means that an individual's loan account would need to be broken into separate parts, one for each of the years of lending to that person. There was doubt as to whether the scheme's valuation model and the agencies' accounting systems could have coped with this complexity in 2006.

Ministry of Education Comment

11. "The Ministry of Education considered it necessary to ask Ministers to agree to the changes as making the change is a deliberate, discretionary decision that had not previously been available to government (as previous accounting systems had not enabled agencies to identify each year of lending separately). Ministers have placed significant emphasis on accuracy and stability of the student loan scheme in recent years, however because of the trade-offs between accuracy on the one hand and increased volatility on the other, the change represented a choice between these objectives. The change has the effect of 'correcting' the cost of lending in that the new approach reflects current costs more precisely. For that reason, the Ministry of Education argues that the tertiary education allocation should receive recognition of the savings made from the change, either through them counting directly or by provision of an allocation. "

12. Treasury considers the improvement in the accuracy of the calculation of the cost of lending a technical change.

13. We recognise that the Ministry of Education needed a steer from Ministers over what they were to focus on in their management of the Student Loan Scheme (as noted above).

14. However, this does not constitute a policy change. For example, ACC makes numerous changes to its valuation on an ongoing basis to improve the accuracy of its forecast costs. Similarly the Ministry for Social Development makes improvements in its forecast models. In both instances these are regarded as technical changes, rather than policy changes, as they have no impact on individuals or groups (eligibility or obligations). The change to the basis of costing of lending corrects a weakness in the costing and brings the costs into line with what the accounting standard had always envisaged.

Impacts on the Budget Package for Tertiary Education

15. Treasury's advice is that savings from any technical change in the Student Loan Scheme should be returned to the centre and recognised through the March Baseline Update.

16. The Budget 2013 package for Tertiary Education may not require these savings in order to balance, if additional spending initiatives are excluded (i.e. increase in funding for science, engineering and Private Training Establishments, which the Minister for Tertiary Education, Skills and Employment has indicated are priorities for him in Budget 2013).

17. The Ministry of Education has informed us that the overall balance of the package would then be net savings of $1.155 million over 4 years. However, this figure does not take account of administration costs or transition options, e.g. grandparenting options for the Student Support initiatives and hence, the current net savings may become a net cost.

18. [6]

19. When considering the package, Ministers may wish to recognise that the centre has benefited from changes to the calculation of the cost of lending in the Student Loan Scheme, and agree to an increase in the baseline for Vote Tertiary Education from the operating allowance to fund additional spending initiatives.

20. Note the Ministry of Education has identified the following profiles which will be considered by SOC on Wednesday 27 March:

a) maintain the savings in the tertiary education allocation based on their current profile

	Operating impact ($ million)					
	2012/13	2013/14	2014/15	2015/16	2016/17	5 year total
Changing calculation of cost of lending for the loan scheme	(41.900)	(33.900)	(18.000)	(7.400)	(0.800)	**(102.000)**

b) return the savings to the centre and provide an allocation that reflects the average impact over 10 years of these savings

	Operating impact ($ million)					
	2012/13	2013/14	2014/15	2015/16	2016/17	5 year total
Changing calculation of cost of lending for the loan scheme	(10.200)	(10.200)	(10.200)	(10.200)	(10.200)	**(51.000)**

c) return the savings to the centre and provide an allocation that reflects the additional costs of preferred spending initiatives of the Minister for Tertiary Education, Skills and Employment, but no more than the average spread of the savings over the current forecast period:

	Operating impact ($ million)					
	2012/13	**2013/14**	**2014/15**	**2015/16**	**2016/17**	**5 year total**
Changing calculation of cost of lending for the loan scheme	(20.400)	(20.400)	(20.400)	(20.400)	(20.400)	**(102.000)**

Next Steps

21. We recommend that you discuss this paper with the Minister for Tertiary Education, Skills and Employment before 9am on Friday 22 March. This will allow the Minister for Tertiary Education to include the decision in his two Budget 2013 Cabinet papers at SOC for 27 March, and enable the Budget 2013 tertiary education package to be finalised by Budget Ministers.