



HM TREASURY

Financial Reporting Advisory Board Paper

Treatment of Student Loans – Change in Cost of Capital Charge

Issue:	The accounting treatment for student loans was agreed under FRAB (30) 3. The mechanics of the accounting treatment assumed that the rate for cost of capital would reflect the discount rate. The change in discount rate for long term liabilities to 2.2% from 1 Apr 05, whilst the cost of capital remained at 3.5%, has meant that compliance with FRAB (30) 3 is no longer possible.
Impact on guidance:	No impact on FReM
UK GAAP adaptation?	N/A
IAS/IFRS compliant?	N/A
IPSAS compliant?	N/A
Impact on budgetary regime?	Yes
Recommendation:	The Board is asked to endorse the proposal that for student loans only the cost of capital match the discount rate for long term liabilities (currently 2.2% real).
Timing:	The change would be effective from 1 Apr 05.

DETAIL

Background

1. Student loans are subsidised. They carry, in effect, a rate of interest equivalent to the rate of inflation; they are presented as interest-free loans, with students making equivalent payments to inflation.
2. The subsidy is calculated as the difference between the cost of capital on the outstanding loans and the interest earned. A provision for this subsidy is set up at the time the loan is made and will be a discounted figure in accordance with FRS 12.

3. In order to reflect the full extent of the subsidy when the loan is issued and to ensure that the mechanics of the provision did not result in further charging to DfES's operating cost statement (OCS) over the life of the loan, the Board agreed to the current accounting treatment for student loans in FRAB (30) 3 (December 1998).

4. The accounting treatment set out by FRAB (30) 3 assumed that the rate for cost of capital would reflect the discount rate, with the result that inflation, cost of capital, provision release, interest receivable and unwinding transactions within the OCS balance to nil.

Effects of changes to Discount Rates and Cost of Capital Charges

5. In 2002 the Board questioned the link between the discount rate and cost of capital charge during its deliberations over the reduction in both rates from 6% to 3.5%, but as both of these rates were subsequently accepted, there was no impact on the accounting treatment under FRAB (30) 3.

6. The Board agreed to revise further the rate for non-pension liabilities to 2.2% with effect 1 Apr 05. There has been no change to the rate for cost of capital, which remains at 3.5%. This change to the discount rate only has meant that DfES can no longer comply with the agreed accounting treatment for student loans.

7. The impact on the department is that it will continue to bear the cost of 3.5% as the subsidy, but only 2.2% of which will be included in the provision and charged in the year of issue. The remainder will be charged annually over the life of the loan as the release of the provision based on 2.2%, but charge costs calculated at 3.5%.

Options

8. In order to restore parity with the FRAB (30) 3 accounting treatment a number of options were considered:

- a. **Retain discount rate at 3.5%.** Given the lengthy discussion that has already taken place at recent meetings on this issue, it was felt in appropriate to consider a further additional rate specific to student loans.
- b. **Amend the cost of capital rate to 2.2%.** The setting of cost of capital was until recently linked with that of the discount rate. The setting of the cost of capital rate is also at the discretion of the Treasury.
- c. **Accounting Adjustment.** The accounting treatment of student loans under FRAB (30) 3 is already complicated by the need to make an inflation adjustment as part of the calculation. It is felt that an additional accounting adjustment, which would effectively restore the position to one of the above options, would add an unnecessary complication.

9. Due to the unique nature of these loans and the highly complex model used by DfES to calculate the provision, it is proposed that the cost of capital for **student loans only** should be amended to reflect that of the discount rate for long-term liabilities (currently 2.2% real).

Impact on the budgetary regime

10. In budgetary terms the impact of this change will be treated as a classification change but for current and forward years only and therefore budgets (2005-06, 2006-07 and 2007-08) will need to be adjusted to reflect the impact. The intension is that DfES will be no better or worse off as a result of managing this change outside of the spending review process and therefore DfES's settlement will be adjusted to reflect the impact in the SR2004 years only.

Summary and recommendation

11. The accounting treatment for student loans was agreed under FRAB (30) 3. At the time it was assumed that the rate for cost of capital would reflect the discount rate. However, with the change in discount rate for long-term liabilities from 1 Apr 05 and with the cost of capital remaining at 3.5%, compliance with FRAB (30) 3 is no longer possible. In order to restore parity again, it is proposed that, for student loans only, the cost of capital match the discount rate for long term liabilities (currently 2.2% real).

HM Treasury

