Securitization of income contingent student loans – breaking new ground

Overview and background

In December 2017 we acted for the UK Government on its first securitization of income contingent student loans (**ICR Loans**), which involved the largest ever sale of student loans in the United Kingdom. As the amount of public student loan debt in the UK rapidly approached £100bn, the UK Government has been seeking to sell some of that loan book to the private market. This process began in 2010 but took almost seven years to complete, given the complexity of the asset and intervening events.

The transaction was designed to take the relevant loan book off the public balance sheet by transferring risk in the loan book to the private sector. The proceeds of the sales will go towards reducing public sector net debt, which as at the end of October 2017 stood at approximately £1.8tn.

Summary of the Transaction

As a part of the transaction, approximately £3.7bn of ICR Loans were sold by the UK Government to an orphan special purpose vehicle (the **Issuer**). The Issuer issued four tranches of notes backed by the pool of ICR Loans, the junior-most of which (i) bear interest at a fixed interest rate and (ii) include an entitlement to collections remaining available after all other costs of the transaction have been paid.

How is the Transaction different from previous UK Student Loan Securitisations?

The UK Government has previously sold portfolios of student loans which were then securitized by the private sector purchasers (including the "Honours" and "Thesis" transactions). There are two principal differences between the securitization of ICR Loans and these earlier transactions. These differences relate to the underlying asset class as well as the post sale servicing arrangements.

The types of loans securitised in Honours and Thesis are significantly different from ICR Loans. Honours and Thesis were backed by "mortgage style" loans (**MSL**), which are repayable over a fixed number of instalments irrespective of the amount the borrower is earning. In contrast, repayments under ICR Loans are calculated at a repayment rate multiplied by earnings above a repayment threshold. This results in a more flexible "loan" product for the borrower under which repayments are adjusted depending on employment status and earnings of the borrower.

The other key difference is that repayments for the loans securitized as part of the Honours and Thesis transactions were collected directly by the Student Loans Company (**SLC**) prior to the sale through direct debit and other standard payment channels. The servicer appointed by the buyer took over this function after completion of the sale. Unlike Honours and Thesis, repayments of the ICR Loans are (and continue to be after sale) collected by HM Revenue and Customs (**HMRC**) and Student Loans Company (**SLC**). Consequently borrowers are unaffected by the sale and continue to deal with SLC in relation to their loan account. In addition, the investors in the loan portfolio have the benefit of the majority of collections being made directly through the UK tax system by HMRC.

Key features of the Transaction

As with many "first-of-its-kind" transactions there were many challenges which required new and innovative solutions to be developed to achieve a successful completion.

Permission to sell

At the time the UK Government decided to sell the book of ICR Loans, there was no legislative framework under which the ICR Loans could be transferred. The Education (Student Loans) Act 1998, pursuant to which MSLs had been sold was repealed when MSLs were replaced by income contingent repayment loans in 1999. The UK Government relied on a specific Act of Parliament to enable the sale; the Sale of Student Loans Act 2008 (the **SSLA**).

The UK Government can adjust loan terms

The UK Government retained the right to adjust the terms of the ICR Loans following the sale. This could potentially have an adverse impact on the return to the investors. Accordingly, pursuant to its powers under the SSLA, the UK Government agreed not to make certain changes to the loan regulations (including amendments which cause a reduction to the interest rate, an increase to the repayment threshold, a reduction in the repayment rate and a change to the write-off date) unless the UK Government compensated the Issuer for any material losses caused as a result of such amendment. Various other key amendments also trigger payment of compensation. The way in which compensation is to be calculated means that compensation should only be payable by the UK Government where it has made a specified amendment to the loan terms and that there is a difference between actual collections on the loan and what those collections would be if the amendment had not been made. This gives investors certainty as to the terms of the ICR Loans. For the UK Government the compensation provisions allowed it to ensure that all borrowers (whether or not their loan has been sold) will continue to be treated in the same way.

Collections of receipts

As with any other loan portfolio, the performance of the servicer is a key factor in the performance of the ICR Loans and investors would usually expect to have a right to replace the servicer for breach of its obligations under the relevant transaction documentation. Repayments on the ICR Loans are largely collected through the UK tax system and continue to be so

collected following the securitisation. Given the unique position of HMRC as an entity collecting repayments through the UK tax system and given the policy of treating borrowers of sold and unsold ICR Loans equally, it would not be possible for a private entity to replicate or be involved in the collection of repayments of the ICR Loans. To deal with the practical inability of investors to replace the UK Government as master servicer even if it breaches any of its obligations (which in another asset class would be a servicer termination event) the master servicer must, in those cases, prepare and implement a remedial plan. The remedial plan would set out the way in which the master servicer proposes to remedy the breach or for the master servicer to indemnify the Issuer. This would help the Issuer compensate the investors for any loss caused to them as a result of breach of the master servicer's obligations in relation to the ICR Loans.

The transaction also maintains collections of repayments on the ICR Loans through the UK tax system and servicing of the loans by SLC broadly to the standards which those parties collect and service unsold loans. In this way HMRC and SLC could maintain "business as usual" processes in relation to the sold loans (as well as the unsold loans).

Risk Retention

As well as being structured to comply with EU risk retention requirements under Article 405 of the CRR, Article 51 of the AIFMR and Article 254 of the Solvency II Regulation, the risk retention needed to be compatible with the UK Government's objective of achieving off-balance sheet treatment for the UK Government accounting rules. This was achieved through the UK Government retaining a randomly selected pool of loans equal to at least 5% of the securitised portfolio which would have otherwise been eligible for sale into the securitisation.

Matching Adjustment

To encourage investment in the transaction by insurance companies, certain classes of the notes issued by the Issuer were structured to support insurance company investors allocating the notes to their "matching adjustment" portfolio under the Solvency II Regulation

What next?

- This was the largest ever sale of student loans in the UK. It was also the first time anywhere in the world ICR loans have been securitised creating an entirely new asset class – notes backed by income contingent loans.
- The successful conclusion of this transaction has opened the door for the UK Government to continue its commitment to, subject to market conditions, sell further portfolios of Plan 1 (pre-2012) student loans over the following four financial years, and indicates that the securitisation market remains open to new and innovative asset classes.

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