Australian Prudential Regulation Authority consultation on targeted changes concerning the treatment of Higher Education Loan Program debt repayments when assessing home loan applications

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I thank APRA for the opportunity to make a contribution to its consultation[1] on the way financial institutions treat HECS[2] debts and repayments for the purpose of assessing home loan applications. This brief submission should be read in tandem with my submission to the recent Senate Economics References Committee inquiry into Australia's financial regulatory framework and home ownership (submission 46, attached), and the Committee's report.[3]

This is not an institutional submission – the views expressed here are my own – but these observations derive from the deep consideration I have given these and related issues over the course of twenty-five years' experience in higher education and research policy.

That experience includes exposure to the deleterious effects on graduates of the incorrect application of assumptions about HELP debts and repayment obligations – based on structural misunderstandings of how HELP operates – that have harmed graduates, their families, lending institutions and the wider economy for decades.

I am delighted that APRA is taking this issue seriously and am grateful for the opportunity to contribute my views. I wish to make two chief points here.

1. <u>Schrodinger's Debt</u>

   HECS is neither a loan nor a grant, in the classical sense of each term. Talk of 'HECS loans' and 'HECS debts' is unhelpful insofar as it is misleading. The obligation both exists and doesn't exist in any given tax year, in practical terms, until the individual's taxable income is determined, and the obligation to repay is either triggered or not (and, if triggered, the rate of repayment is also determined).

   A HECS obligation also differs in kind from conventional loans in that it may never be repaid, and it extinguishes upon death. These characteristics do not constitute 'bad debt' – they are a feature of the policy, not a bug. To treat HECS as though it is a kind of unsecured loan is a category error.

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[1] https://www.apra.gov.au/clarifying-treatment-of-help-debt-obligations
[2] Despite its name change under the *Higher Education Support Act 2003* (HESA) – and the proliferation of related programs for various categories of students, providers and courses – the overall program is still commonly known as HECS and the financial obligation as a HECS debt. For the sake of simplicity, I use the term 'HECS'.
[3] https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Economics/Homeownership/Report

2. <u>HECS should be considered only as an expense, not a capital liability</u>

   Because of these unusual characteristics, HECS is not a capital liability in the classic sense. The meaning of the 'debt' quantum in financial terms relates exclusively to the duration of any repayment obligation, once income exceeds threshold.

   When making assessments of an individual's capacity to service a loan, HECS should only be taken into account when the individual's income that is being factored in is at a level that compels a HECS repayment; and only to the extent of the repayment that must be made at that income level.

   In other words:

   - If an individual loan applicant's income is below the repayment threshold, HECS should not be taken into account at all, as it is not payable at that income level.
   - If an individual loan applicant's income is above the repayment threshold, only the specific HECS repayment equating to that income level should be taken into account, as an expense item (as it is in effect a form of individualised marginal taxation).
   - If a lending institution considers an individual's likely projected increased earnings when assessing loan applications (i.e. if approval processes look not only at current income but also likely future increased income), only the specific HECS repayment levels equating to those elevated future earnings should be taken into account, as an expense item.
   - These calculations should factor to zero once the assumptions of the lending institution's future income model would see the individual's HECS obligation ('HECS debt') extinguished.

To accurately account for HECS, it must be treated as a contingent expense item, to be factored into an applicant's carrying capacity only when, and to the extent that, their taxable income triggers a repayment obligation.

To take a HECS repayment obligation into account when the income is below the level that would trigger that obligation is self-evidently incorrect. It would be like assuming for approval purposes that a worker had an income tax liability in the top bracket while still only factoring in an income in a lower bracket. The repayment obligation is linked to the income earned, just like income tax, and must always be treated as such.

Any other treatment of HECS is irrational, as it does not properly account for the unique properties of the progressive repayment methodology.

ATTACHMENT

Submission to the Senate Economics References Committee inquiry into Australia's financial regulatory framework and home ownership

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I thank the Committee for the opportunity to make a contribution to its inquiry on financial regulation and home ownership. My submission deals with the treatment of income contingent loan (ICL) debts and repayment obligations for the purpose of assessing mortgage applications. These observations derive from the deep consideration I have given these and related issues over the course of twenty-five years' experience in higher education and research policy. This is not an institutional submission: the views expressed here are my own.

The Australian Government introduced an ICL facility called the Higher Education Contribution Scheme (HECS) in 1989, to help it fund a significant expansion of access to higher education. The idea was for the Commonwealth to share the cost of course delivery with the student, who could expect to derive a future private benefit from their education, by means of a repayment obligation managed through the income tax system. No payment was due below a lower threshold of taxable income; bands above the lower threshold corresponded to increasing proportions of income repayable to service the debt. No real interest was charged, but the HECS debt was indexed annually to preserve its real value. Once their HECS debt was extinguished, the graduate[4] owed no further obligation to the Commonwealth under the HECS scheme. The scheme has undergone numerous changes over the ensuing years (including its name – now the Higer Education Loan Program, or HELP[5]) but the structural features relevant to this submission remain intact today.

Especially in the context of the housing affordability crisis, the role of HECS in limiting access to mortgage credit has attracted media attention, although exactly how it does so remains far from clear. There is varying industry advice to potential borrowers on the

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[4] Students who incur HECS obligations by doing individual units of study (or subjects) but do not graduate from their courses (e.g. degrees) are liable for HECS debts accumulated during their enrolments, and one can be liable for the repayment of HECS while still studying, but for the sake of convenience I refer here to workers carrying HECS obligations as 'graduates'.

[5] Despite this name change under the *Higher Education Support Act 2003* (HESA) – and the proliferation of related programs for various categories of students, providers and courses – the wider program is still widely known as HECS and the financial obligation as a HECS debt. For the sake of simplicity, I use the term 'HECS'.

precise role HECS plays in determining their eligibility for a loan and their borrowing power. Some sources state that the capital liability of a HECS debt is assessed in the same way as and alongside any other debt[6]; others say that it is only the loan repayment itself that is important, in determining the applicant's ability to make home loan payments[7]. These contradictory views obscure the situation for potential borrowers generally, but especially for recent graduates who are often confronting the confusing and intimidating world of home financing for the first time. While clarity on how HECS debt balances and HECS repayment obligations should affect home mortgage borrowing power would be welcomed by graduate homeseekers, it is even more important that the treatment of their HECS arrangements is logical, fair, coherent and proportionate.

On 14 June 2022, the Australian Prudential Regulation Authority (APRA) wrote to authorised deposit-taking institutions (ADIs) to advise them of new macroprudential policy credit measures that they were required to meet from 1 September 2022. In the June 2022 letter, APRA responded to queries from some ADIs about whether HECS-HELP debt should be treated as debt for the purposes of debt-to-income ratio (DTI) reporting, by clarifying that HECS loan would be included in DTI reporting.

By issuing this instruction to treat HECS balances identically to other mortgage lending, personal loans, credit cards, consumer finance, margin lending and buy-now/pay-later debt, **APRA has committed a category error** that is very likely inflicting unnecessary hardship upon graduate homeseekers, with no positive effect on actual risk to systemic financial stability.

Although HECS is actually a novel hybrid instrument, it has been described from the start as a type of loan: the sum accrued, as a debt. While HECS has similarities to commercial lending, it has important differences that are significant to this inquiry. Most pertinently, within the terms of the instrument, the obligation need not ever be repaid, if the recipient never earns above a threshold. That's not bad debt: it is built into the model.

It would be no less accurate to characterise HECS as a grant that is repayable under certain conditions than to call it a loan that need not be repaid under certain conditions. Grant acquittal conditions often include the obligation to repay (e.g. underspend, funds spent on non-approved or ineligible items or activities; funds spent outside a set period of time) so it is not a stretch to conceive of HECS as a grant that contains a repayment condition relating to future income derived from the activity supported by the grant.

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[6] For example, https://www.loans.com.au/home-loans/does-hecs-affect-home-loan-application
[7] For example, https://www.realestate.com.au/news/how-student-debts-impact-your-home-loan-borrowing-power/

Indeed, a more structurally accurate way to view HECS than either a debt or a grant is as a profit-sharing scheme, where a sum of money is provided to establish an enterprise (in this case a student's future earning potential) with the obligation to repay not triggered until a threshold level of income is reached that is deemed to be the privately captured benefit of that initial public investment.

Looked at this way, a HECS facility is more akin to an angel investor's convertible note than it is to either a loan or a grant, with the modification that the government 'investor' does not acquire equity, but the right to garnish any wages above threshold until the quantum is extinguished.

If the Committee will indulge me, the HECS mechanism – which is a brilliant, home-grown innovation, by the way – has more in common conceptually with quantum mechanics than it does with financial practice, in that events after the fact in a sense reach back in time to change the nature of the transaction. A HECS obligation is Schrödinger's debt: it is simultaneously both a debt and a grant, with the 'wave function' collapsing once the graduate starts earning – the sum being either a debt or a grant depending on the graduate's income at any given time. If the threshold income is never achieved, then the HECS obligation is a grant, and has always been a grant; should the threshold income be reached, then it becomes a repayable loan; if the income dips below the threshold again, then it reverts to a grant to which the graduate has partially repaid; when the graduate dies, any balance is extinguished as though that portion has always been a grant.

There are no doubt good reasons for the Commonwealth to prefer to carry money owed through HECS as debt on its loan book; and no doubt it suits the Commonwealth for the use of this term to focus the minds of those owing HECS obligations to the potential need to repay it. However the spillover of this categorical fudging to the regulatory treatment of the obligation for lenders is an unfortunate, unproductive and probably unintended effect.

There are several other important features that signal that a HECS obligation is different in kind to a financial loan from a DTI:

- There is no application and approval process, akin to a bank loan application (eligible students are entitled to 'draw down' on the facility once they are accepted into uni);
- It attracts no interest – its nominal value is indexed only to hold its real value;
- It is extinguished upon the death of the graduate, rather than becoming a liability to their estate.

For these reasons, the nature of a HECS obligation is different in kind to that of a bank loan debt. Most significantly, it should not be viewed as a capital liability on the graduate's balance sheet. Instead, it is a potential obligation on their profit and loss statement, that is only realised at a particular percentage once their taxable income has hit threshold. The quantum of the obligation determines the duration of this income garnishment but does not otherwise function as a standard financial liability.

APRA should revise its advice to DTIs to take into account the HECS repayable at the levels of income lenders are basing their lending decisions on – whether current or projected future earnings – but not as a capital liability. In other words, an applicant's obligation to make HECS repayments should only be taken into account in the context of their receipt of the income that triggers that obligation in actuality. The quantum of HECS owed is not particularity useful to this assessment – it is the earnings versus expenditure assessment that is pertinent. It is grossly unfair to applicants – and economically inhibiting – for them to have HECS held against them when they are not earning enough to repay it.