REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 816
SESSION 2010–2011

4 MARCH 2011

**Department for Business, Innovation and Skills**

**Higher Education Funding Council for England**

# Regulating financial sustainability in higher education

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**Department for Business, Innovation and Skills**
**Higher Education Funding Council for England**

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Amyas Morse
Comptroller and
Auditor General

National Audit Office

2 March 2011

This report examines the Funding Council's regulation of the financial sustainability of Higher Education Institutions in England, which include its duties monitoring the financial health and risk of institutions.



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The National Audit Office study team consisted of:

Paul Bilton, Sarah Chennells, Richard Douglas, Andrew Epps, Thabang Nonyane, Richard Ratcliffe and Paul Wright-Anderson under the direction of Peter Gray

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For further information about the National Audit Office please contact:

National Audit Office
Press Office
157-197 Buckingham Palace Road
Victoria
London
SW1W 9SP

Tel: 020 7798 7400

Email: enquiries@nao.gsi.gov.uk

Website: www.nao.org.uk

Twitter: @NAOorguk

# Summary

## Scope of our report

**1** The higher education sector in England includes 129 autonomous Higher Education Institutions (institutions) funded by the Higher Education Funding Council for England (the Funding Council). The sector's annual income exceeds £22 billion, with almost half coming directly from public sources such as the Funding Council. In the 2009-10 financial year ending March 2010, the Funding Council distributed a total of £7.9 billion to institutions and incurred £19 million in administration costs (including around £2 million on its activities related to regulating financial sustainability).

**2** The Funding Council aims to work in partnership to promote and fund high quality, cost-effective teaching and research. It oversees the sector's financial sustainability and is accountable to the Department for Business, Innovation and Skills (the Department). The Department has assigned the Funding Council certain duties, including monitoring the financial health and risk of institutions, and promoting value for money. Institutions' governing bodies have responsibility for their own financial sustainability.

**3** The higher education sector makes an important contribution to the economy and society. In the 2008/09 academic year, students in England achieved 566,000 higher education qualifications and UK institutions published 91,000 research papers (8 per cent of the world's total). England's top institutions have regularly scored very well in international surveys comparing the quality of higher education institutions.

**4** The sector is facing unprecedented change following the Government's adoption of the main recommendations of the Browne Report.[1] This entails moving to a more market-based system in which the funding for undergraduate teaching will primarily follow the student via higher tuition fees, which most students are likely to finance through publicly provided, income-contingent loans. In addition, the Government is reducing direct public funding to institutions, and remaining funding flowing via the Funding Council will be targeted on high cost subjects or specific policy areas such as widening participation.

**5** This report examines the Funding Council's regulation of the financial sustainability of Higher Education Institutions in England, which includes its duties to monitor the financial health and risk of institutions. The report examines whether the Funding Council's approach to assessing and responding to risks affecting the sustainability of institutions is risk-based, efficient and effective in protecting the taxpayers' interest.

1 *Securing a sustainable future for higher education*, Independent review of higher education funding and student finance, October 2010.

## Key findings

**6 In recent years, the sector has achieved strong growth in its income and increasing robustness in its financial sustainability.** In real terms, income grew by an annual average of 6 per cent in the four years up to July 2010 (totalling £4.3 billion), reflecting higher fees for full-time undergraduates and an increase in student numbers. Expenditure rose slightly less quickly than income with staff costs, the largest component, rising in real terms by an average of 4 per cent a year. The sector's total financial surplus (historical cost) rose from 2.0 per cent of income in 2005/06 to 3.6 per cent in 2009/10.

**7 The Funding Council is operating a cost-efficient approach to regulating financial sustainability.** The Department has not prescribed how the Funding Council should approach financial regulation, but has emphasised the need for a lighter touch regime. Within an administration budget of £19 million a year, the Funding Council spends around £2 million (12 per cent) on regulating financial health. It has sought to apply a risk-based approach to minimise the regulatory cost and it has been effective in maintaining the confidence of institutions. Lenders report that the Funding Council's regulatory framework has contributed to their confidence in the sector, reducing the costs of borrowing. No institution has failed in a disorderly manner, for example, leaving creditors unpaid or students unable to complete their course, since the Funding Council was set up in 1993.

**8 The Funding Council's assessment of financial sustainability of institutions covers the medium-term risks effectively, but for short term risks it should reinforce the obligation it places on institutions to report material adverse changes.** The set of financial indicators applied annually by the Funding Council to all institutions, as well as other Funding Council processes, is appropriate for assessing the medium-term sustainability of institutions. This approach is less suited to assessing institutions' short-term position which can change rapidly. The Funding Council may be alerted to short term risk through, for example, its contacts with various sector bodies and other contacts with institutions. The Funding Council is also partly dependent on institutions to self-report 'material adverse changes' to their position. However, in our judgement, evidence indicates that not all such variations may be reported, possibly owing to insufficient guidance from the Funding Council.

**9 The Funding Council has a structured process for identifying institutions it judges to be 'At Higher Risk' but will need to review and adapt these arrangements to reflect forthcoming changes within the sector.** The Funding Council's risk rating constitutes a broad assessment of threats to an institution's sustainability, not just its financial sustainability, and an institution categorised as 'At Higher Risk' is not necessarily at risk of collapse. The Funding Council bases its judgements on the range of information it receives using a framework set out in its Financial Memorandum with institutions. As it considers the future regulatory framework, there is scope for the Funding Council to use a more systematic approach to brigading its evidence against the chosen risk criteria and to adopt a more graduated risk assessment system – at present, 95 per cent of institutions are assessed as 'Not At Higher Risk'.

**10 The Funding Council publishes an annual assessment of risk within the sector but does not routinely publish its assessments of individual institutions.** The Funding Council shares risk assessments with institutions and other funding bodies. It delays publishing the identities of institutions At Higher Risk by three years, and potentially longer, to give the institutions time to rectify their difficulties and make appropriate provision for their existing students. As a greater proportion of funding begins to follow the student, however, the Funding Council needs to consider the balance between protecting institutions and their students, on the one hand, and enabling prospective students to take more informed decisions on where to study, on the other.

**11 Some institutions in difficulty take a long time to resolve their weaknesses.** The seven institutions rated At Higher Risk in July 2010 had been in the category for over four years on average, with one institution considered At Higher Risk for 12 years. Institutions are statutorily independent and the Funding Council has no power to take over the running of an institution in serious difficulty. Instead, the Funding Council works closely with institutions, attempting to resolve weaknesses through effective action from their governing bodies. There is uncertainty about whether, in law, the taxpayer might be liable for the liabilities of an institution should it become insolvent.

**12 The funding of higher education is changing, necessitating a new framework for financial regulation.** Following the Browne Report, the Government decided to allow institutions to increase tuition fees charged to undergraduates from 2012/13, reduce grant funding from the Funding Council and encourage the development of a market. The current framework of regulation operated by the Funding Council relies on the terms and conditions set out in the Financial Memorandum that accompanies the grant funding. In the future, grant funding will diminish significantly as a source of institutions' income. The Department and the Funding Council are considering the implications for financial regulation of the sector.

**13 The new funding framework, coupled with the squeeze in public funding, is likely to increase the level of risk within the sector.** While there are a number of financially strong institutions, there is wide variation in institutions' financial performance and over 25 per cent of institutions in 2009/10 were performing below at least one of the financial benchmarks. Nine per cent of institutions have had a deficit in at least two of the last three years. The Funding Council's modelling indicates that while some institutions will benefit financially from the funding reforms, some will, by 2014/15, receive less public income and tuition fee income supportable by student loans.

**14 In the new environment, the Funding Council's capacity to provide support to the sector may become stretched.** The Funding Council's current approach to supporting At Higher Risk institutions has absorbed significant amounts of the Funding Council's senior manager and regulatory staff time. The Funding Council is unlikely to be able to support a more substantial caseload without either stronger powers to intervene effectively or more regulatory resources.

## Conclusion on value for money

**15** The Funding Council has overseen the financial sustainability of the higher education sector through a period of growth in income and student numbers. At a direct cost of around £2 million a year, it has contained the cost of its own regulatory activities and sought to limit the burdens it places on the sector, focusing on those institutions at highest risk. Within the context in which it has operated to date, and despite the issues that we mention in this report on the assessment of risk, the Funding Council has delivered value for money.

## Future considerations for the Department

**16** The higher education sector is facing a period of transition to a very different financial environment in which institutions will compete for students whose places will be funded primarily through undergraduate tuition fees backed by government finance. The transition and the new environment itself will increase the risk within the sector, potentially raising the number of institutions at high risk of failing, and stretching the existing resources of the Funding Council. Addressing these risks may require a new framework for regulation and a new regulatory approach within that framework. The Department should take this opportunity to set clear expectations of the approach adopted by the Funding Council and what it should achieve. We consider that the Department should convey its expectations in respect of:

- the objectives of the regulatory framework;
- the priority that the Funding Council must give to its regulatory work compared to the other demands on its administrative resources;
- whether and when the Funding Council should intervene where an institution faces actual or potential difficulty, and what powers it should have to protect the interests of taxpayers and students;
- the Funding Council's role with respect to higher education providers that receive no grant funding but do receive tuition fees financed by student loans; and
- when to manage the taxpayers' disengagement from an institution should this be in the public interest.

## Supplementary recommendations

17 In addition to our main recommendation in paragraph 16, the Funding Council has scope to strengthen its arrangements.

a **The Funding Council is partly dependent upon institutions to report deterioration in their financial position.** The Funding Council should provide clearer guidance to institutions on when to report material adverse changes in their financial position. It should promote the importance of timely reporting of material adverse changes.

b **The Funding Council will need to review its risk assessment processes to match the new funding environment within the sector.** The Funding Council should review its procedures for assessing and categorising risk to match the new funding environment. It should take the opportunity to adopt a more systematic approach to brigading its evidence against the chosen risk criteria and a more graduated risk assessment system.

c **The Funding Council delays by at least three years its publication of its assessment of risk at individual institutions.** As a greater proportion of funding begins to follow the student, the Funding Council should consider whether the current arrangements strike the right balance between protecting institutions and their students, on the one hand, and enabling prospective students to take more informed decisions on where to study, on the other.

# Part One

## Background

**1.1** Currently, 129 Higher Education Institutions (institutions) receive funding from, and are regulated by, the Higher Education Funding Council for England (the Funding Council). The Funding Council is a non-departmental public body funded by the Department for Business, Innovation and Skills (the Department). This part of the report provides background on the institutions and the role of the Department and the Funding Council.

### Higher Education Institutions

**1.2** Institutions deliver higher education teaching and/or research, and receive funding from the Funding Council to do so. Most, but not all, can award degrees and most can use the title 'university'.[2] A small number of other organisations can award degrees and have university status. These do not receive funding from the Funding Council, although their students may have access to publicly provided loans. Institutions vary greatly in terms of their balance between teaching, research and other activities. The largest institution has an annual income exceeding £1 billion, while around a quarter of institutions have an income below £50 million.

**1.3** Institutions are autonomous bodies, separate from government and able to decide their own strategies and policies. In the 2009/10 academic year, public bodies provided the sector with almost half its total income. The sector received a further £2.7 billion (12 per cent of total income) from undergraduate tuition fees supportable by student loan.[3] All institutions but one are charities. Institutions' governing bodies are responsible for their performance, maintaining their financial sustainability, accounting for public funds, and complying with charity law.

2 The power to award degrees and the (separate) right to use the title 'university' have been conferred by Royal Charter or Act of Parliament. Since 1992, the Privy Council has exercised this role.

3 Tuition fees supportable by a student loan are currently those charged to full time undergraduates and students doing postgraduate teacher training. The Government has announced that this will be extended to part time undergraduate students from 2012/13.

**1.4** The higher education sector in England contributes to the economy and to society, through its two main activities of teaching and research. For example, in 2008/09:

- 1.5 million full-time equivalent students attended institutions and 566,000 higher education qualifications were attained in England; and
- across the UK as a whole, 91,000 research papers were produced (8 per cent of the world total), and citations of UK research accounted for 12 per cent of the world's total.

**1.5** Overall, English institutions are well regarded internationally. England was rated, for example, second best in the world, behind the United States, in both the Academic Ranking of World Universities (with 31 institutions in the top 500) and the QS World University Rankings. This overall strong performance is matched by the United Kingdom being the second most popular destination for the world's foreign students in higher education.

## Recent financial trends

**1.6** In recent years the sector has experienced income growth, with an average (real terms) increase of 6 per cent per annum since 2005/06. The main sources of growth were the introduction of variable tuition fees for full-time undergraduates and increasing fees from students from outside the European Union (**Figure 1**).

**1.7** Between 2005/06 and 2009/10, the sector's income grew in real terms by £4.3 billion; 84 per cent of this was reflected in increased expenditure (including £1.9 billion on increased staff costs) (**Figure 2**).

**1.8** Staff costs are the largest component of costs, accounting for 56 per cent of total expenditure in 2009/10. Between 2005/06 and 2009/10, staff costs grew at an average annual rate of 4.3 per cent, which is slower than the overall rate of income growth. Up to 2008/09, staff numbers, on a full-time equivalent basis, grew by an average of 2.2 per cent per annum, while average salaries, in real terms, increased by 2.9 per cent per annum (compared with a 0.4 per cent increase in the whole economy). The increases partly reflect the sector's response to evidence in the late 1990s; for example, the report of the Bett Committee argued that pay for most staff in higher education was below that of their equivalents in other sectors.[4]

**1.9** Outputs have also risen, with student numbers and qualifications, for example, both increasing by around 2 per cent per annum from 2005/06 to 2008/09. Although the rise in student numbers and qualifications has been slower than the rate of income growth, this does not necessarily mean that productivity has fallen. Assessing productivity is not within the scope of this report.

4 *Independent Review of Higher Education Pay and Conditions (Bett Review)*, 1999.

## Figure 1

Institutions' income, 2009/10

| | 2009/10 (£bn) | Average annual increase after inflation 2005/06 to 2009/10 (%) |
|---|---|---|
| **Teaching** | 12.6 | 7 |
| Of which: | | |
| Funding Council grant | 5.1 | 1 |
| Tuition fees for UK and EU resident full-time undergraduates | 2.7 | 28 |
| Tuition fees from students resident outside the EU/UK | 2.1 | 10 |
| Other tuition fees and grants | 2.7 | 4 |
| **Research** | 5.3 | 5 |
| **Other** | 4.3 | 3 |
| **Total income** | **22.2** | **6** |

NOTES
1 Figures are for academic years, and the average annual increase adjusts for inflation using the GDP deflator.
2 'Other income' includes charges for services, donations and investment income.

*Source: National Audit Office analysis of Funding Council data*

## Figure 2

Institutions' income, expenditure and operating surpluses, 2005/06 to 2009/10

| | 2009/10 (£bn) | Total increase after inflation since 2005/06 (£bn) | Average annual increase after inflation 2005/06 to 2009/10 (%) |
|---|---|---|---|
| Total income | 22.2 | 4.3 | 6 |
| Less: | | | |
| Staff costs | 12.1 | 1.9 | 4 |
| Non-staff costs | 7.8 | 1.4 | 5 |
| Interest and depreciation | 1.6 | 0.4 | 8 |
| Operating surplus | 0.7 | 0.6 | 52 |

NOTES
1 Figures are for academic years, and the average annual increase adjusts for inflation using the GDP deflator.
2 'Non-staff costs' includes goods and services, including information technology, premises and bursaries.

*Source: National Audit Office analysis of Funding Council data*

## The Department and the Funding Council

**1.10** The Department sponsors the Funding Council and determines its overall funding. Under legislation intended to protect academic freedom, the Department cannot direct the Funding Council as to which institutions, or which courses and areas of research, to fund. In other areas the Department provides a limited amount of guidance and instruction. In its financial memorandum the Department assigns the Funding Council certain duties, including monitoring the financial health and risk of institutions, and promoting value for money.[5] In its annual grant letters, announcing the funding it is making available to the Funding Council, it also sets out its policy priorities and any particular ways in which it would like the Funding Council to act in support of them. Its directions to the Funding Council are pitched at a high level, allowing the Funding Council scope to decide how to implement them in practice. The Department also sponsors other non-departmental public bodies with a significant role in the sector, including the seven research councils which together provide 6 per cent of institutions' income.

**1.11** The Funding Council was established by the Further and Higher Education Act 1992. In financial year 2009-10, the Funding Council distributed £7.9 billion to institutions and other organisations, a third of the sector's total income, and incurred £19 million in administration costs.

**1.12** The Funding Council's mission is to 'work in partnership to promote and fund high quality, cost-effective teaching and research, meeting the diverse needs of students, the economy and society,' and its Strategic Plan contains seven strategic aims (**Figure 3**). The Funding Council's four key functions are:

- administration of funding and implementation of public policy initiatives;
- regulation of the higher education sector and accountability for public money;
- policy development and advice to government and others; and
- promotion of good practice within institutions.

**1.13** The Funding Council has limited statutory powers. Most of its powers in respect of institutions derive from its statutory power to attach conditions to its funding. These conditions are set out in a Financial Memorandum with institutions, on which it is required by legislation to consult the sector. The Financial Memorandum sets out certain requirements that institutions must follow (such as concerning the role of auditors and audit committees), consent requirements for borrowings above certain limits, and the approach of the Funding Council to the support of and engagement with institutions.

5 Department for Education and Skills, *Financial Memorandum between the Department for Education and Skills and Higher Education Funding Council for England*, June 2006.

## Figure 3
The Funding Council's seven strategic aims

**Enhancing excellence in learning and teaching**

To ensure that all higher education students benefit from a high-quality learning experience fully meeting their needs and the needs of the economy and society.

**Widening participation and fair access**

To promote and provide the opportunity of successful participation in higher education to everyone who can benefit from it.

**Employer engagement and skills**

To encourage transformational change in the higher education sector that will enhance the capability of institutions to establish long-term, sustainable relationships with employers to stimulate and meet their demands for highly competent and skilled employees.

**Enhancing excellence in research**

To develop and sustain a dynamic and internationally competitive research sector that makes a major contribution to economic prosperity and national wellbeing and to the expansion and dissemination of knowledge.

**Enhancing the contribution of higher education to the economy and society**

To increase the impact of the higher education knowledge base to enhance economic development and the strength and vitality of society.

**Sustaining a high-quality higher education sector**

To sustain a high-quality higher education sector which adapts to the developing needs of stakeholders, and which continues to be recognised as world class.

**Enabling excellence**

To ensure we can effectively deliver our strategic plan, working to the highest standards in all that we do.

*Source: Funding Council, Strategic Plan 2006-11*

**1.14** The Funding Council has a statutory duty to ensure there is assessment of the quality of teaching in the institutions it funds. It discharges this duty by contracting with the Quality Assurance Agency to run quality assurance arrangements. The Agency is an independent body, funded by subscriptions from universities and colleges and by contracts with the Funding Council and other funding bodies.

**1.15** A recent review[6] of the Funding Council (the Burslem Review), commissioned by the Funding Council and chaired by Dame Sandra Burslem, concluded that it was a 'high performing organisation that has the confidence of the higher education sector and the Government.' The review identified some challenges ahead, including to the consensual and consultative model for policy development adopted by the Funding Council in its role as broker between the Department and institutions.

6 *Independent Review Group review of the effectiveness and efficiency of the Higher Education Funding Council for England*, Oakleigh Consulting Limited, March 2010.

**1.16** Following the Charities Act 2006, the Funding Council was appointed in June 2010 as principal regulator, responsible for overseeing compliance with charity law by 110 institutions. The Funding Council works with the Charity Commission to achieve this. Previously these institutions were exempt from regulation by the Charity Commission, on the assumption that they were already subject to similar forms of regulation. The Charity Commission retains responsibility for directly regulating the 18 institutions that are registered charities and were never exempt.

## Forthcoming changes

**1.17** The system for funding teaching in institutions and finance for students is set to change substantially following Lord Browne of Madingley's recent review.[7] Since then the Government has been considering potential changes to the sector, so far announcing that it will:

- increase from £3,290 to £9,000 the cap on annual fees chargeable by institutions to undergraduate students for tuition;
- significantly reduce the sector's reliance on teaching grant from the Funding Council, such that most income follows the choice of students; and
- open up the sector to new providers.

**1.18** In its grant letter to the Funding Council in December 2010, the Department advised that government funding to institutions, including payments of tuition fees, would decline from £9.8 billion in the 2010-11 financial year to £9.2 billion in 2011-12 and an indicative figure of £9.4 billion in 2012-13.

## This report

**1.19** This report examines the Funding Council's regulation of the financial sustainability of higher education in England, focusing on its approach to assessing risk (Part Two) and its capacity to respond to institutional risk (Part Three). Our study methods, including financial analysis, interviews, a census and visits to institutions, are summarised at Appendix One.

7 *Securing a sustainable future for higher education, Independent review of higher education funding and student finance (Browne Review)*, October 2010.

# Part Two

## The Funding Council's assessment of risk

**2.1** This part examines the Funding Council's approach to assessing risk in the sector, in particular whether its:

- system for assessing institutional and financial risk is effective; and
- arrangements for assessing the financial outlook for the sector are reasonable.

### Basis of the Funding Council's regulatory oversight

**2.2** Through its annual grant letters the Department has sometimes provided the Funding Council with direction regarding its regulatory role. The emphasis has changed over the years, from sound financial management to a lighter touch accountability regime in the mid-2000s. The Department's advice on regulation has remained at a high level, and not prescribed how the Funding Council should respond.

**2.3** The Funding Council seeks to operate a regulatory framework that encourages effective institutional accountability and successful identification and management of risks to sustainability. It seeks to impose costs or burdens only where necessary to achieve these aims.

**2.4** Legislation empowers the Funding Council to fund institutions subject to whatever conditions it sees fit.[8] It places responsibility on the governing body of institutions for accounting for the use of public money and complying with the terms of the Financial Memorandum.

**2.5** By academic year 2014/15, some institutions will receive little grant funding, with the disappearance of teaching grant for many subjects and, possibly, greater concentration of research funding. Higher education providers not in receipt of grant funding are currently not subject to the Funding Council's regulatory requirements.

8 Further and Higher Education Act 1992.

## Assessment of institutional risk

**2.6** The Funding Council's assessment of institutional risk is central to its effectiveness as a regulator. The sources of information which it uses to judge institutional risk are set out in the Financial Memorandum and can be summarised as:

- an annual accountability return from all institutions covering financial performance, financial forecasts, student numbers and assurances and information on the use of funds, risk management, control and governance;
- the Funding Council's institutional audit processes including data audits, carried out approximately every three years, and assurance reviews, carried out approximately every five years;
- contact, at least annually, between the Funding Council and the institution to discuss priorities, strategies and reporting of adverse developments; and
- relevant information from institutions, other funders or other sources, including assessments by the Quality Assurance Agency.

### Classification of risk

**2.7** Based on the information available, the Funding Council classifies each institution as being either At Higher Risk or Not At Higher Risk. In December 2010 seven institutions were classified by the Funding Council as being At Higher Risk. Out of 129 institutions, between four and seven have been judged to be At Higher Risk in the last five years. Following the release of information by the Department, *The Sunday Times* identified the seven institutions that were At Higher Risk in May 2009.[9]

**2.8** The Funding Council's decision to designate an institution as At Higher Risk is made by the Chief Executive on the advice of an Internal Risk Review Group. The decision is based on judgement using a qualitative and quantitative review of the information available. The Financial Memorandum sets out the reasons for such a designation, being that an institution:

- faces threats to the sustainability of its operations, either now or in the medium term;
- has serious problems relating to value for money, propriety or regularity; or
- has materially ineffective risk management, control or governance.

9 J Grimston and M Newman, 'Universities claim millions for dropouts' *The Sunday Times*, 9 May 2010.

**2.9** These broad criteria are supported by internal guidance covering the process and issues to consider. The Funding Council does not have comprehensive criteria to guide this judgement as it considers that each institution is unique. The Funding Council bases its judgements on the range of information it receives. As it considers the future regulatory framework, our work suggests there is scope for the Funding Council to use a more systematic approach to brigading its evidence against the risk criteria.

**2.10** The Funding Council's binary risk rating system classifies 95 per cent of institutions as Not At Higher Risk. Therefore it does not show users of the ratings how close a particular institution is to being assessed as At Higher Risk. The Funding Council has highlighted areas of concern to some institutions. The use of this process has grown from 10 cases in 2007 to 43 cases in 2010. There are many reasons for having concerns highlighted and receiving comments is not a good indication of becoming At Higher Risk in the near future. Only one of the four institutions designated At Higher Risk since 2007 had concerns raised with them in the preceding year. In March 2010, the Funding Council accepted the recommendation of the Burslem Review that it should consider making its risk assessments clearer and more informative. Following a limited consultation with the sector, the Funding Council has decided that no changes will be made at present but that it will consider doing so once changes in higher education policy and funding became clearer.

## Transparency

**2.11** The Funding Council does not normally disclose publicly its assessment of risk at individual institutions within three years, because it considers that:

- disclosure could harm the commercial position or sustainability of an institution;
- disclosure could impair the provision given to current students;
- disclosure could undermine the Funding Council's relationships with institutions, who may wish to discuss issues; and
- in its view, students are already provided with sufficient information on institutions.

**2.12** The Funding Council makes a public disclosure of its assessments and interventions after three years, so long as it considers there would be no harm to current students or the institution. The delay in disclosure is intended to allow institutions time to address their problems which might otherwise become more difficult to resolve if the problems became known. The Funding Council may make its assessment public if it believes that there are strong public interest grounds, and it has done so on one occasion since agreeing these arrangements with the Information Commissioner's Office in 2006. In November 2009, the Information Tribunal heard an appeal by the Funding Council relating to a Freedom of Information request for information on the quality of institutions' estates. The Tribunal concluded that the factors in favour of disclosure, including giving relevant information to those faced with a choice of institution, substantially outweighed those in favour of the Funding Council maintaining confidentiality. This gave the Funding Council a valid public interest defence to any breach of confidentiality claim in respect of estates data.

## Assessment of financial risk

**2.13** The most likely reason for an institution to be placed At Higher Risk is that it faces threats to its financial sustainability. The Funding Council assesses financial sustainability at both sector and institutional level based on its annual collection of financial results and forecasts in December. The Funding Council uses six main indicators to assess financial sustainability and supplements these where appropriate. The Funding Council identified these indicators in 2007 as the most likely indicators of threats to the long-term financial sustainability of institutions. For each of the indicators, the Funding Council has an internal benchmark which is used to highlight areas of potential concern (**Figure 4**). Missing a benchmark does not mean that an institution is At Higher Risk; a judgement on this will require consideration of a broader range of qualitative and quantitative factors.

### Figure 4
The Funding Council's key financial indicators

| Indicator | Benchmark used to highlight areas of potential concern |
|---|---|
| Net liquidity (days of expenditure) | Less than or equal to ten days in two or more years in succession |
| Net cash flow from operating activities (percentage of income) | Negative in two or more years out of three |
| Historical cost surplus or deficit (percentage of income) | A deficit in two or more years out of three |
| Staff costs (percentage of income) | More than 64 per cent in any year |
| Affordability of borrowing (percentage of income). This indicator is measured using an average of annual payments (interest and capital) over the period of outstanding loans | More than 4 per cent |
| Discretionary reserves (percentage of income) | Less than 10 per cent in any year |

*Source: Funding Council Annual Accountability process for 2009*

**2.14** An indicator set such as this only provides a snapshot of the sector's financial sustainability, providing a prompt for further investigation where necessary. We consider that two of the indicators, net cash flow from operating activities and historical cost surplus or deficit, are most appropriate as measures of financial health in the medium term. They also provide an appropriate set of indicators for this time frame. We consider that three of the indicators – staff costs, affordability of borrowing and discretionary reserves – look at financial health over the long term. These indicators do not cover important aspects of long-term financial health, such as pensions and estates, although the Funding Council considers these in its wider assessment of institutional risk.

**2.15** The remaining indicator, net liquidity, is a measure of financial health in the very short term. The Funding Council collects audited financial information and forecasts annually, four months after the year end. By this time, any problems highlighted by this indicator are likely either to have passed or to have materialised as serious difficulties. Under the terms of the Financial Memorandum, the Funding Council does require institutions to gain consent if they expect to have negative net cash of more than 5 per cent of income for 35 consecutive days, which is much lower than the liquidity benchmark. Since August 2005, four institutions have obtained this consent.

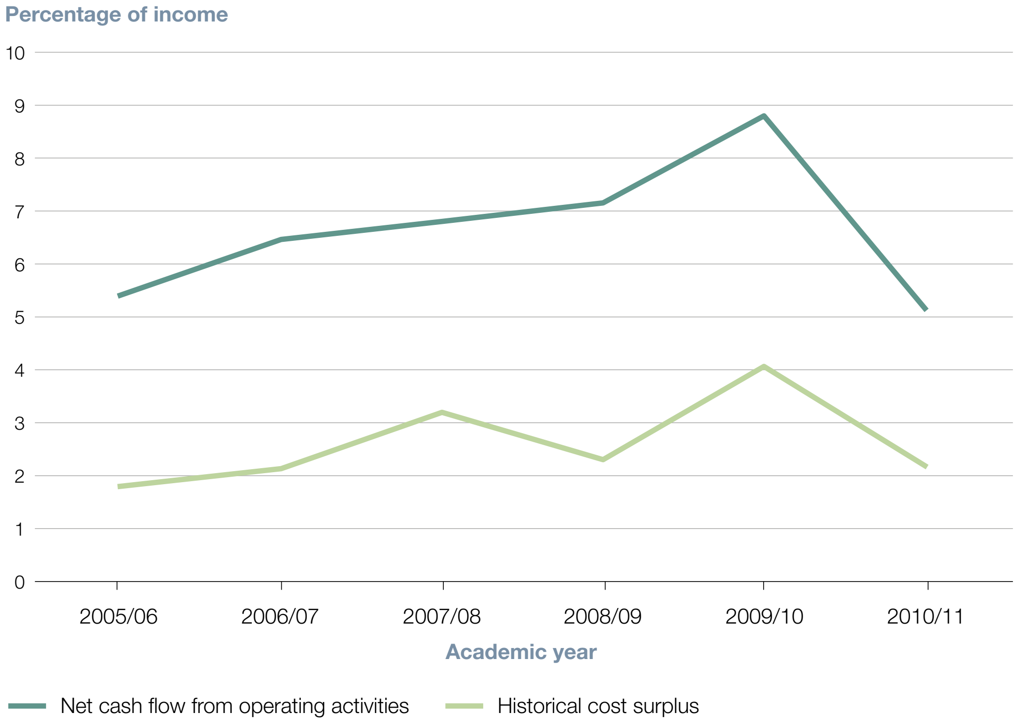
**2.16** Some information on important mid-year changes will become apparent to the Funding Council through its other sources of information (paragraph 2.6). A key source is self-reporting by institutions, and so the Funding Council requires institutions to report anything that is a 'material adverse change' in its circumstances. The Funding Council provides three broad examples of what constitutes a material adverse change – significant and immediate threat to financial position, significant fraud, or major accounting breakdown – but relies on individual institutions to judge what might be material in their context. The Funding Council considers that these are appropriate arrangements for autonomous institutions. Since January 2010, when the Funding Council started to log these reports, seven institutions have self-reported. However, applying an illustrative threshold developed by us (more than 5 per cent of income), another seven institutions suffered significant reductions of net cash flow from operating activities or in surpluses (historical cost) compared to in-year 2009/10 forecasts submitted to the Funding Council. None of these institutions alerted the Funding Council through this process although evidence indicates that a report was clearly unnecessary in a minority of these cases. Another institution in early 2009 made an urgent and unexpected request for grant to be paid early due to poor forecasting of cash requirements. There is a risk that failure by an institution to report a material adverse change could result in additional costs and resource requirements from the Funding Council.

## Overall financial sustainability

**2.17** The Funding Council's most recent sector level report, for 2008/09, concluded that the sector was in a 'fairly sound financial position albeit [with] a marginal deterioration on the previous year.' The report noted the need for the sector to control costs better and that the overall level of surpluses was low.[10] Our analysis of data on the institutions' performance in 2009/10 and recent forecasts for 2010/11 shows improvement followed by a forecast deterioration (**Figure 5**).

**Figure 5**

Higher education institutions: Medium-term indicators of financial sustainability, 2005/06 to 2010/11




**NOTE**

1 Graphs show the sector median. The sector's total surplus (which is different to its median surplus) increased from 2.0 per cent of income in 2005/06 to 3.6 per cent in 2009/10. Data for 2010/11 come from forecasts provided to the Funding Council in December 2010.

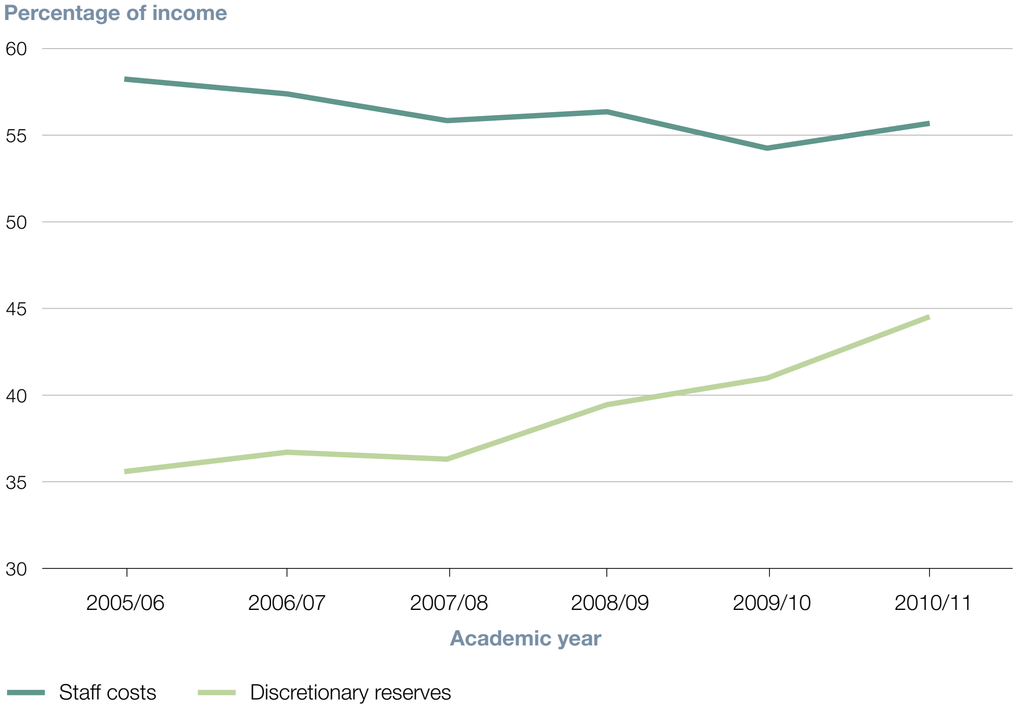
*Source: National Audit Office analysis of Funding Council data*

10 *Annual accountability returns: Outcomes for 2009*, Higher Education Funding Council for England, July 2010.

**2.18** Two important long-term indicators of financial sustainability, staff costs and discretionary reserves (both as a percentage of income), show improvement across institutions (**Figure 6**). Reserves improved across the period, reflecting the investment of surpluses into buildings and other physical infrastructure. Again, this supports the Funding Council's view that the sector was in a fairly sound position in 2008/09.

## Figure 6

Higher education institutions: Long-term indicators of financial sustainability, 2005/06 to 2010/11




**NOTE**

1 Graphs show the sector median. Data for 2010/11 come from forecasts provided to the Funding Council in December 2010.

*Source: National Audit Office analysis of Funding Council data*

**2.19** Although financial sustainability in the sector as a whole appears sound, there is considerable variation. We have modified the Funding Council's methodology to exemplify the trend in performance over the five-year period ending in 2009/10. Our analysis suggests a sizeable minority of institutions operated below the current Funding Council benchmarks during this period, suggesting they were running a higher level of risk (**Figure 7**). The total number of institutions operating below one or more of the Funding Council benchmarks decreased from 45 to 35 over the five-year period, but this was during a relatively benign economic and financial environment. In 2009/10, 9 per cent of institutions had operated with deficits in at least two of the previous three years. Further analysis suggests that by the end of 2009/10 it was some of the non-medical research intensive institutions and the specialist music and arts institutions that were more likely to be operating below the benchmarks (**Figure 8**).

## Figure 7

Institutions operating below current benchmarks

| Academic year | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|
| **Number of institutions operating below benchmark** | | | | | |
| Historical cost surplus | 17 | 22 | 16 | 15 | 12 |
| Net cash flow | 13 | 14 | 11 | 10 | 7 |
| Affordability of borrowing | 13 | 16 | 18 | 17 | 16 |
| Staff costs | 8 | 11 | 7 | 8 | 4 |
| Net liquidity | 7 | 1 | 3 | 5 | 3 |
| Discretionary reserves | 5 | 3 | 3 | 4 | 1 |
| **Total** | **63** | **67** | **58** | **59** | **43** |
| **Number of institutions operating below** | | | | | |
| 1 benchmark | 33 | 30 | 36 | 32 | 28 |
| 2-5 benchmarks | 12 | 17 | 10 | 10 | 7 |
| All 6 benchmarks | 0 | 0 | 0 | 0 | 0 |
| **Institutions operating below 1 or more benchmark** | **45** | **47** | **46** | **42** | **35** |
| **Percentage of all institutions** | **35%** | **36%** | **35%** | **33%** | **27%** |

NOTES

1 The number of institutions in the sector varies slightly each year as a result of mergers, institutions joining the sector and data availability.

2 Benchmarks for some indicators cover multiple years. For example, to count as having been below the historical cost surplus benchmark in 2005/06, an institution needs to have recorded a deficit in two or more of 2005/06, 2004/05 or 2003/04.

3 This analysis is based on audited actual figures. It is not a reproduction of the Funding Council process, which also features forecast data from institutions and in which benchmarks change over time. Using the Funding Council methodology, in 2008/09 66 institutions would have triggered one or more indicator.

*Source: National Audit Office analysis of Funding Council data*

## Figure 8
Institutions operating below benchmarks, academic year 2009/10

| Peer group | Institutions operating below 1 benchmark | | Institutions operating below 2 or more benchmarks | |
|---|---|---|---|---|
| | Number of institutions | Percentage of peer group (%) | Number of institutions | Percentage of peer group (%) |
| **A** Institutions with medical schools | 5 | 25 | 0 | 0 |
| **B** Non-medical research intensive institutions | 11 | 58 | 1 | 5 |
| **C** Mixed teaching and research institutions | 0 | 0 | 1 | 7 |
| **D** Large teaching institutions | 3 | 16 | 1 | 5 |
| **E** Medium-size teaching institutions | 1 | 4 | 1 | 4 |
| **F** Small teaching institutions | 3 | 20 | 1 | 7 |
| **G** Specialist music and arts institutions | 5 | 26 | 2 | 11 |
| **Total sector** | **28** | **22** | **7** | **5** |

NOTES
1 The number of institutions in the sector varies slightly each year as a result of mergers, institutions joining the sector and data availability.
2 Benchmarks for some indicators cover multiple years. To count as having been below the historical cost surplus benchmark in 2009/10, for example, an institution has recorded a deficit in two or more of 2007/08, 2008/09 or 2009/10.

*Source: National Audit Office analysis of Funding Council data*

**2.20** In contrast, another group of institutions have performed particularly strongly. For example, 37 institutions recorded surpluses in excess of 5 per cent of income in at least two of the three years ending 31 July 2010; and at that date, five institutions had reserves exceeding 100 per cent of their income, and 12 institutions had no long-term borrowings. All five institutions with very substantial reserves have accumulated surpluses, before pension liabilities, exceeding 60 per cent of their income and two of those institutions also have substantial discretionary endowments.

**2.21** Each year, the Funding Council publishes a report on the financial position and outlook for the sector. The report for the academic year 2008/09 was published in July 2010. The 2010 report included commentary on the performance of the overall sector and its forecasts. Institutions additionally receive information that shows their own position against the sector's mean, median, top and bottom quartile position over the last year and forecast period.

## Assessing the financial outlook for the sector

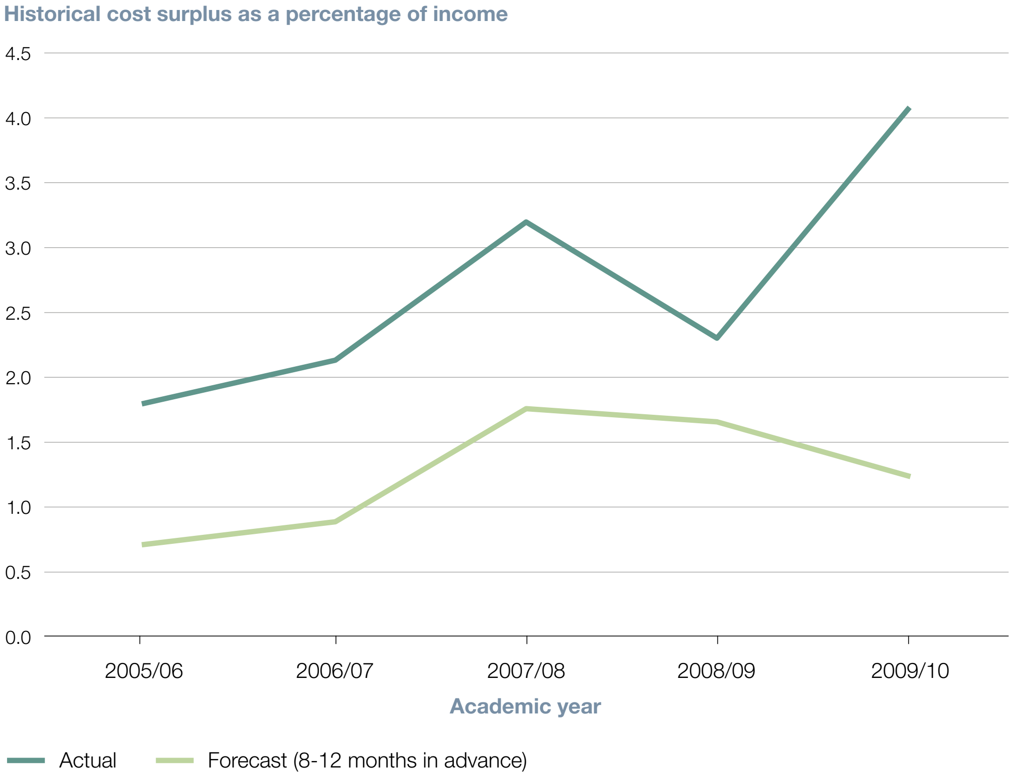
**2.22** Over the next two to three years the sector faces significant changes to its funding arrangements. These changes will reduce the overall level of public funding; shift reliance towards income earned from student fees; and place greater onus on the ability of individual institutions to adapt quickly to a changing environment. The Government has asked the Funding Council to focus on supporting a smooth transition for all institutions to the new arrangements. We examined previous financial forecasts submitted to the Funding Council and its modelling of the potential impact of the changing environment.

### Institutions' financial forecasts

**2.23** Alongside information on current financial performance, the Funding Council asks institutions to submit forecast financial information for the current year and three future years. In 2010, institutions were asked to provide data for the current academic year but were given the option to delay submission of their three-year forecasts until April 2011 owing to the current uncertainties about public funding.

**2.24** Previous forecasts have tended to underestimate the performance of institutions (**Figure 9**). In the 2009/10 academic year, 94 institutions improved their surpluses or deficits by more than 1 per cent of income compared to the forecast they had submitted to the Funding Council earlier in the year. In 28 cases, the actual surplus exceeded forecast by more than 5 per cent of income. Eight institutions achieved surpluses of more than 1 per cent of income below their forecast in 2009/10, with two institutions achieving a surplus/deficit below forecast by an amount in excess of 5 per cent of income.

## Figure 9
Higher education institutions: Forecast and actual historical cost surpluses, 2005/06 to 2009/10




**NOTES**
1. Graphs show the forecast and actual median institution performance.
2. For 2005/06 and 2006/07, forecasts were submitted in the July preceding the year in question, e.g. July 2005 for the 2005/06 year. From 2008/09, forecasts were submitted in the December preceding the year in question, e.g. December 2008 for the 2008/09 year. 2007/08 was a transition year with some institutions submitting forecasts in July and some in December.

*Source: National Audit Office analysis of Funding Council data*

**2.25** The Funding Council's annual process of collecting forecasts also requires institutions to tell them what scenario planning work has been undertaken. We found that 64 per cent of institutions complied with this basic requirement in 2009, including 27 per cent of institutions that went beyond the requirement by providing financial information. The Funding Council's ability to model the impact of changes on the sector would be enhanced by more complete data on scenario planning.

## The Funding Council's financial modelling

**2.26** The Funding Council has developed, and is refining, a model to identify institutions that may face a 'going concern' risk during the transition phase to a new funding regime and in the longer term. Its current modelling includes assumptions on student demand, fee levels, public funding from a variety of sources, and other changes such as student finance for part-time students currently being developed by the Government.

**2.27** We examined this model and found it to be reasonably comprehensive, covering a wide range of the known risk factors. This is necessarily a 'live' model, a work in progress, and there is scope to develop it further. For example:

- The model uses forecasts submitted by institutions in 2009. The Funding Council did not specify the assumptions to be made by institutions. As a result, institutions have made a variety of assumptions for public funding.
- The scenarios do not include the potential impact of some institutions growing their share of the undergraduate market and/or the entry into the undergraduate market of new providers.

**2.28** The Funding Council's modelling (December 2010) shows that the changes are likely to have a differential impact on institutions with, by 2014/15, some institutions seeing a rise in their public income and tuition fee income supportable by a student loan while others face a decline. On the basis of this modelling and forecast data due from institutions in April 2011, the Funding Council will carry out an update of which institutions are At Higher Risk and how many could be At Higher Risk in the future.

# Part Three

## The Funding Council's capacity to respond

**3.1** This part examines the Funding Council's approach to dealing with cases requiring support, in particular:

- whether its approach to intervention has been effective; and
- whether it has the capacity to respond to increased financial risks where it needs to do so.

### Interventions in institutions at risk

**3.2** The Funding Council advised us that its intention in designating a Higher Education Institution At Higher Risk is to target its monitoring and engagement, and to signify that it will work with the governing body and institutional managers to ensure that appropriate action is taken to manage and lessen the risks. In addition, under the Financial Memorandum, the designation enables the Funding Council to take further action such as changing conditions of grant. Since the Funding Council was formed (in 1993), there has been no disorderly failure of an institution. Whilst some poorly performing institutions have been taken over by other institutions, the avoidance of a collapse has helped maintain confidence amongst stakeholders.

**3.3** In recent years the average length of time that institutions have been At Higher Risk has grown. The Funding Council does not have a predetermined period within which it expects an institution to have addressed its problems and moved out of the At Higher Risk category. In July 2010, the seven institutions then classified as At Higher Risk had, on average, been so for 4.3 years, up from 2.7 years in July 2006 (**Figure 10** overleaf).[11] Thames Valley University has remained At Higher Risk for 12 years (**Figure 11** on page 29).

11 Excluding the institution At Higher Risk for the longest period, the average time in the category increased from 1.7 years in 2006 to 3.1 years in 2010.

## Figure 10

Institutions At Higher Risk: Number of cases and time in category


**NOTE**

1 Average time is measured from the time an institution became At Higher Risk until the academic year (31 July) in question. It is not identical to the average time from becoming At Higher Risk until exit. Institutions enter and exit At Higher Risk during the period and only institutions At Higher Risk at the end of the academic year are included when calculating average time.

*Source: National Audit Office analysis of Funding Council data*

**3.4** In the past five years, two institutions have moved out of the At Higher Risk category:

- Middlesex University, after three years, was deemed to have reversed its deteriorating financial sustainability, through strengthened senior management, restructuring, and estates rationalisation;

- Trinity Laban experienced some problems following a merger, which had been supported by additional funding from the Funding Council. The institution subsequently improved its financial health and management team, recovering after nearly three years.

## Figure 11
Thames Valley University

The Funding Council classified Thames Valley University in the late 1990s as being At Higher Risk due to under recruitment and low retention of students. It has recorded an historical cost deficit in five of the last six years and has had concerns highlighted against two of the Funding Council's benchmark indicators every year since 2005/06.

The University has had several changes of Vice Chancellor, and there have been various changes in strategy. For example, its strategy to grow higher education student numbers was abandoned after failing consistently to recruit sufficient students, and in 2004 it diversified into large scale further education. In 2008 it decided to locate the University fully in west London, divest itself of its further education provision in Reading and close its Slough campus.

The Funding Council has had regular contact with the University. In 2010, a set of milestones was established between the Funding Council and the institution based on the University's plan for sustainability, including rolling quarterly financial performance and key success criteria. The University and the Funding Council report that all agreed metrics are being met or exceeded.

*Source: National Audit Office*

## The Funding Council's approach

**3.5** The Funding Council's approach to dealing with institutions assessed At Higher Risk is described in the Financial Memorandum. It is obliged to follow the commitments set out in the Memorandum unless there are good reasons not to do so. These commitments include, for example, an initial period of engagement with senior management in all cases, followed by an assessment of the institution's strategies and actions. The Funding Council maintains closer contact with these institutions, monitoring their financial position more regularly than for other institutions.

**3.6** Ultimately, the Funding Council may take a number of actions, as set out in its Financial Memorandum. These include actions such as:

- acting as observer at governing body meetings;
- requesting the appointment of interim managers;
- requiring a recovery plan;
- encouraging exploration of collaborative opportunities with other institutions;
- attaching additional conditions of grant; and,
- in extreme cases, withdrawing funding from an institution.[12]

12 Funding Council, *Model Financial Memorandum between the Higher Education Funding Council for England and institutions*, July 2010.

**3.7** The Funding Council has sometimes provided additional funding to help finance measures (for example, to support a merger with another institution, or to provide consultancy advice) intended to improve an institution's financial sustainability. It has limited the scale of funding earmarked for this purpose. Between August 1999 and December 2010, the Funding Council has in total given special grant funding of £44 million, and loans of £11 million, to all institutions in its At Higher Risk category (for example, see **Figure 12**). This total support funding equates to less than 0.1 per cent of the overall funding provided by the Funding Council over this period. The seven institutions currently At Higher Risk have, between them, benefited from special grant funding totalling £8 million (including £1 million paid to consultants for advice), plus another £8 million of special loan funding. This excludes advances of teaching grant that the Funding Council had made in response to cash flow problems at two of these institutions. As with other institutions, the Funding Council has allowed institutions At Higher Risk to retain their allocation of undergraduate numbers so long as they can recruit the students.

## Figure 12
### Special grant funding to Ravensbourne

The Funding Council has made special grant payments to Ravensbourne totalling £2.1 million and a loan of £2 million. This has been used to part fund relocation to purpose-built premises, at a total cost of £65 million.

The Funding Council provided financial support because the scale of the project (over four times the institution's income) carried significant risk to the taxpayer in terms of continuity of provision. The grant enabled Ravensbourne to procure specialist project management support and protected the taxpayer by requiring further consent from the Funding Council should the design or cost of the project change.

The Funding Council monitored the project through quarterly, and at times monthly, financial accounts and project progress reports as well as meetings with Ravensbourne's senior managers and governors. The project is now complete.

*Source: National Audit Office*

**3.8** The Funding Council may support institutions At Higher Risk to resolve their problems through merger, but institutions have achieved only limited success through this approach. In recent years, merger has helped one institution At Higher Risk and is expected to help another. However, in the case of Thames Valley University, a merger with a further education college was backed by a £2 million grant (half of it repayable) from the Funding Council. The merger has now been reversed as part of the institution's new improvement strategy, which has the support of the Funding Council (see Figure 11).

**3.9** The Funding Council has launched a project to learn lessons from past collaborations, alliances and mergers with a report and guidance to be published in 2011. This project will also contribute to policy in this area and develop practical advice for institutions.

**3.10** Although the Funding Council maintains regular engagement with institutions, it remains heavily reliant on gaining cooperation from governing bodies to address institutional weaknesses. As institutions are autonomous bodies, the Funding Council has no power to step in to take over the running of an institution. Gaining cooperation from an institution can take time. Whilst such cooperation has generally been evident in recent years there have been occasional cases where the Funding Council and individual institutions have disagreed on the causes and resolution of problems, most notably in the case of London Metropolitan University (see **Figure 13**), leading to a protracted dispute.

## Figure 13
Difficulties at London Metropolitan University, 2007-2009

As part of its data assurance processes the Funding Council audits institutions' student data returns to check that institutions are receiving funding for only eligible students who meet the Funding Council's rules. The Funding Council carried out audits of London Metropolitan University in 2004, 2005 and again in 2007. The 2007 audit and subsequent investigations ultimately led to an unprecedented adjustment of £15 million to the University's annual grant as well as clawback of £36.5 million of previous years' grants. The Funding Council designated the University At Higher Risk in May 2008, once it had clarified the scale of the funding adjustments. Under pressure from the Funding Council, the Vice Chancellor left in March 2009. In December 2009, the University decided to replace all non-executive governors by the summer of 2010.

The Funding Council's engagement with the University was marked by serious disagreements as to the cause, scale and resolution of the issues. Between the Funding Council and the University, five independent reviews were produced. Taken together, these concluded that:

- the length of time to resolve the issues was in part due to their scale and complexity;
- the Funding Council could have acted more quickly in response to the early problems;
- commissioning consultants to undertake a detailed review severely strained relations between the Funding Council and the University;
- from 2007 to 2009, communications between the Funding Council and the University were poor;
- governance and management arrangements at the University were not operating effectively; and
- the Funding Council needed to develop its capacity and capability to deal with future cases, especially if more than one occurred at the same time.

*Source: National Audit Office analysis of five reports produced in 2009 and 2010 by BDO, KPMG, Deloitte, Sir David Melville and Eversheds.*

**3.11** Following lessons learned from the London Metropolitan University case and its experience of other cases, the Funding Council consulted on and reissued its Financial Memorandum in 2010. The revised version provides clarification of the expectations of governing bodies and states that where a governing body is not discharging its duties, the Funding Council might place the institution in its At Higher Risk category and attach special conditions to its funding. The Financial Memorandum also states that, although it has no power to remove the head of an institution, the Funding Council may ask a governing body to appoint a new senior manager to the role of Accountable Officer[13] (although this does not mean that the head of institution would have to be replaced).

13 Senior officer, normally the head of institution, who is designated as being responsible for reporting to the Funding Council on behalf of the institution.

**3.12** Beyond the case of London Metropolitan University, the Funding Council does not routinely carry out lessons learned exercises to review its handling of these cases. It does, though, share knowledge at the regular meetings of its Institutional Risk Review Group. In general, the Funding Council does not have internal guidance on handling At Higher Risk cases which could be updated as lessons are learned. In part this reflects the varied circumstances that lead to an institution being At Higher Risk. But it also leaves the Funding Council reliant on key staff with experience, creating a risk should those staff leave or the number of institutions At Higher Risk increase.

**3.13** The powers available to and regulatory approach taken by the Funding Council contrast with those of some other regulators – for instance, Monitor, the regulator which aims to ensure that NHS Foundation Trusts are well-led and financially robust. Monitor has stronger powers than the Funding Council: for example, once a Trust is identified as being at significant breach, the highest risk category, Monitor can make appointments to the board and remove members of staff. There are also other differences: for example, Monitor publishes the names of those Trusts identified as being at significant breach, and aims to move them out of that category within 24 months. It also requires quarterly reporting of financial performance from all Trusts. There are, of course, a number of differences between the sectors regulated by Monitor and the Funding Council. Some of the contrasts between their approaches noted here may, for instance, reflect the fact that NHS Foundation Trusts have less autonomy and less private funding than higher education institutions. In citing the example of Monitor we are not suggesting that it has been the more effective regulator, or that its regulatory powers and approach would necessarily be appropriate for the Funding Council. However, we are observing that an alternative model, with greater public transparency about judgements of risk, is possible.

**3.14** Institutions, with support from the Funding Council, have so far avoided unmanaged insolvency. Were an institution to become insolvent, advice commissioned by the Funding Council has indicated that outstanding liabilities might fall to the Secretary of State and that the cost might be significant. However, there is no case law to clarify how the insolvency of an institution might unfold.

## The Funding Council's capacity

**3.15** The Funding Council's total administrative expenditure in 2009-10 was £19 million, including £12 million (65 per cent) of staff costs. The Funding Council employed 233 full-time equivalent staff in 2009-10, of which we estimate that 29 full-time equivalents (12 per cent) were engaged in activities related to the oversight of financial health (and not the full range of its regulatory functions).[14] This equates to around £2 million, including a proportionate share of non-staff costs. These activities include routine engagement with institutions, assessing institutional risk and working with those identified as At Higher Risk.

14 Including its staff at 'related bodies', such as the Joint Information Systems Committee, the Funding Council's total staff comes to 265.

**3.16** The cost to the sector of compliance with sector-specific regulation was estimated to be £167 million in 2007-08.[15] Much of this total does not relate to the Funding Council, instead arising from bidding for research council funding, for example; although it does include around £10 million in respect of Funding Council monitoring of financial health. These figures exclude the costs of institutions' internal processes on which regulators rely. Private lenders have suggested the sector's strong track record has had, in return, a direct impact on reducing the cost to the sector of private finance.

**3.17** The administrative costs of the Funding Council are low compared with similar grant-distributing bodies (**Figure 14**). For example, its running costs as a percentage of its overall expenditure (0.24 per cent) are less than half those of its Scottish and Welsh equivalents (0.52 and 0.63 per cent, respectively).

## Figure 14
Running costs of the Funding Council compared to other funding bodies, 2009-10

| Organisation | Total net expenditure (£m) | Running costs (£m) | Running costs as percentage of total net expenditure (%) |
|---|---|---|---|
| Higher Education Funding Council for England | 7,872 | 19 | 0.24 |
| Scottish Funding Council | 1,919 | 10 | 0.52 |
| Higher Education Funding Council for Wales | 475 | 3 | 0.63 |
| Learning and Skills Council[1] | 12,850 | 247 | 1.92 |

NOTE
1 The Learning and Skills Council serviced over 2,400 providers, which is much more than the comparators, through a network of local offices. Removing £85 million from its running costs, which relate to operating its 47 offices and depreciation, reduces its running costs to 1.26 per cent of total net expenditure.

*Source: Annual reports and accounts of each body*

**3.18** Supporting institutions At Higher Risk makes significant demands on the time of the Funding Council's assurance staff. In the 15 months to July 2010, the Funding Council's assurance staff recorded spending 77 days on work related to each institution At Higher Risk on average, or 18 per cent of their assurance time. In addition, challenging cases have absorbed significant amounts of senior manager and institutional engagement team time. In March 2010, the Burslem Review concluded that, in view of the probability of an increase in this workload, the Funding Council should reassess the resources it deployed on institutional assurance. The Funding Council is likely to face a more substantial caseload as the sector makes the transition to a new funding regime (see paragraph 2.28). The Funding Council is currently providing advice to the Department, while the latter works on future funding and regulatory arrangements.

15 PA Consulting Group, *Positive Accountability: Review of the costs, benefits and burdens of accountability in English higher education*, January 2009.

# Appendix One

## Study methods

| Method | Purpose |
|---|---|
| Analysis of financial data from all 129 institutions, 2005/06 to 2009/10. | To examine changes in financial health of the sector; and to reflect on the extent to which the Funding Council's regulation of individual institutions is consistent with their underlying financial health. |
| Semi-structured interviews with Funding Council. | To identify systems used in regulation of the sector. |
| Semi-structured interviews with Departmental officials. | To understand its relationship with the Funding Council and policy and funding objectives. |
| Census of institutions (109 responses out of 129 institutions). | To gauge the sector's views on regulation by the Funding Council. |
| Visits to six institutions: Bishop Grosseteste University College; Leeds Metropolitan University; London Metropolitan University; University of Birmingham; University of Durham; and University of Hertfordshire. | To gain knowledge of the Funding Council's assurance and relationship management processes, and insights into the sector's views on regulation. |
| Observation of two assurance review visits and one data audit. | To gain insights into the effectiveness of the Funding Council's regulatory visits. |
| Semi-structured interviews with comparator bodies (Monitor and Scottish Funding Council). | To reflect on the appropriateness of the Funding Council's approach to financial risk assessment. |
| Semi-structured interviews with sector bodies and other third parties (e.g. a major bank). | To gain wider information about the financial health of the sector. |
| Analysis of the sector's value for money savings as reported by the Funding Council. | To reflect on the robustness of savings claimed for the sector by the Funding Council and Department. |

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