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Department for Business, Innovation and Skills

Higher Education Funding Council for England

Regulating financial sustainability in higher education

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.