# Financial sustainability of registered providers

## Issue

1. The board has previously discussed a range of issues relating to the regulation of both financial sustainability and effective governance in higher education providers. Discussions have covered the challenges of identifying concerns about finances and governance before they become acute, and the need to learn lessons from the responses of other sectors to systemic risk.

2. We have focused on short-term financial risk during the pandemic, and our view remains that, at this time, the likelihood of multiple providers exiting the sector in a disorderly way because of financial failure is low. However, we are aware that higher education providers continue to face a number of uncertainties and potentially significant risks to their financial sustainability and we now need to direct our attention to medium- and long-term perspectives.

3. This paper reminds the board of the approach we have taken to monitoring financial sustainability before and during the pandemic. It also sets out how we propose to develop a more proactive approach to monitoring and intervention as we emerge from the pandemic.

## Recommendations

4. The board is invited to provide advice on the development of our future approach to monitoring the financial sustainability of registered providers and identifying cases where proactive intervention may be necessary.

5. The board is also invited to provide a steer about prioritisation of this activity.

## Further information

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## Background

6. The OfS has a duty to monitor the financial sustainability of registered providers. We do this through condition D, which requires each provider to be:

    a. Financially viable – which means that there is no reason to suppose the provider is at material risk of insolvency within a period of three years.

    b. Financially sustainable – which means the OfS judges that the provider's plans and protections show that it has sufficient financial resources for a period of five years to:

        i. provide and fully deliver the higher education courses as it has advertised and as it has contracted to deliver them; and

        ii. comply with all conditions of its registration.

7. Our general monitoring approach is designed to allow us to identify concerns about viability and/or sustainability for a provider, and to intervene where such concerns create risks for students. We have experience of this type of regulatory intervention for providers that have found themselves in financial difficulties.

8. In March 2020, in response to the pandemic, we adjusted our approach to focus on short-term financial risk. We took a series of actions described in Annex A. We took this approach because:

    a. The short and medium-term impact of the pandemic was highly uncertain, and we recognised that because of this the financial data we held at March 2020 was unlikely to be sufficient to identify providers at risk of financial difficulties.

    b. It seemed likely that the impact of the pandemic would be experienced by most providers, including those that would not normally cause concern about financial sustainability, for example because international student recruitment would be likely to be affected, and this may have system-wide implications.

    c. We were already monitoring a small number of providers more closely and the pandemic may have made their position worse such that immediate intervention was necessary.

    d. The longer-term impact of the pandemic created uncertainty such that seeking to reach judgements about financial sustainability to a 5-year horizon would not have been credible.

    e. Strengthening our regulatory tools to ensure that we could intervene rapidly to protect the interests of students where a provider faced material risk of market exit was essential.

9. This approach allowed us to identify and focus our resources on those providers most at financial risk, engaging with them to ensure they were acting with the speed and focus necessary to ensure credible mitigations were put in place. No provider has closed as a consequence of the pandemic and, while we would not claim that this is a direct consequence of our regulation, it is clear that in some cases our intervention created helpful external pressure to act. Exempt from publication.

10. We are, however, aware that the actions individual providers have taken to mitigate the impact of the pandemic on their financial position may have longer-term implications – for example, additional borrowing will need to be repaid. In addition, we have seen shifts in patterns of undergraduate recruitment over the past two years that may leave some providers with a structural recruitment gap that creates concerns about sustainability.

## Discussion

11. We are now in a position to return to a more normal approach to monitoring financial sustainability. We plan to do two things:

    a. Return to reaching judgements in relation to the 3-year viability and 5-year sustainability horizons set out in condition D.

    b. Exploit the full range of data we hold to proactively identify individual providers that may be vulnerable to particular changes in their operating environment, for example in relation to student recruitment trends, costs of borrowing or pensions

12. The second of these activities would allow us to identify providers that are likely to experience challenges over the medium term and to intervene to test whether their management and governance arrangements, including the capabilities of their boards and senior leaders, are likely to be sufficient to navigate these challenges.

13. Our previous interventions have confirmed that a financial problem for a provider can be a lagging indicator of management and governance issues that may have been present for some time. Our experience also suggests that leadership capabilities that may have been appropriate for a provider in a settled operating environment may not be sufficient in more challenging times – and that the provider itself may not recognise this.

14. Identifying such cases early, by modelling scenarios and acting on this regulatory intelligence, would allow us to prevent a provider from reaching a financial crisis point with all the risks that entails for students.

15. The rest of this paper describes the approach we propose to take to this aspect of our work. It sets out:

    a. The data sets we propose to use.

    b. The factors and scenarios we propose to model to identify individual providers that may be at risk if scenarios occur, singularly or in combination.

    c. The intervention approach we propose to use when our scenario testing suggests this is necessary.

## The data sets we propose to use

16. We collect financial data from each registered provider (except further education and sixth form colleges) as part of an annual financial return. This consists of detailed data about a provider's:

    a. Historic (audited) financial information.

    b. 5-year financial forecasts (detailed income, expenditure, cashflow and balance sheet).

    c. 5-year student number forecast and associated fee income.

    d. Individual borrowing commitments.

17. We also hold other data, including:

    a. Historic student data from HESA, which shows, for example, the mix of students across providers, their mode and level of study and subject area. This also shows student domicile allowing us to see, for example, patterns and trends in the international student market, which can have significant financial implications for individual providers. The mix of students at each provider, including their level, domicile and subject choices, gives us a broad view of the 'market' and the possible impact of changes in the future.

    b. Data from UCAS which shows, for example, historic and current patterns of student applications, offers and acceptances. Regular data deliveries from A level results day show how clearing develops in any particular year.

    c. HESES student data (December/January), which provides in-year data on student numbers at each provider required to make this return. After UCAS data, HESES provides the first view of the number of students that have arrived and registered in any year.

    d. SLC data on withdrawals, which could signal any movement in non-continuation rates.

    e. TRAC costing data which provides information on the split of income and full economic costs across teaching, research and other activities

## The factors and scenarios we propose to model

18. We currently produce sector-wide analysis and reports on the aggregate historic and forecast financial position generated from providers' annual financial returns.[1] Annex B contains examples of our recent modelling work on areas of risk or uncertainty, including potential coronavirus and other risk implications.

19. We also use the data we hold to assess the financial viability and sustainability of individual providers, making judgements about their ongoing compliance with condition D, and triggering regulatory intervention where necessary.

20. As we emerge from the short-term focus of the pandemic we need to shift to a more proactive approach to identifying those providers likely to face future challenges so that we can intervene

[1] https://www.officeforstudents.org.uk/publications/financial-sustainability-of-higher-education-providers-in-england-2021/

before financial risks begin to crystalise. This will involve identifying those trends in the macro environment that we expect to create risk for providers' financial sustainability and to model the impact of a range of scenarios for each trend.

21. The trends in the macro environment we plan to focus on are:

    a. Trends in student recruitment for different market segments, for example recruitment to undergraduate courses from a range of student domiciles, recruitment in geographic regions, recruitment to courses in vulnerable subjects.

    b. Financial trends relating to the developing policy environment in England, specifically relating to the fee and funding regime, theoretical restrictions on student numbers and other (e.g. Augar) proposals.

    c. Financial trends relating to continued pressure on providers' costs, particularly relating to pension scheme contributions and other pay and non-pay costs.

    d. Financial trends relating to the long-run impact of the pandemic, such as changes in assumed income generating activity, including research.

22. Taking one of these as an example, we could model changes in recruitment to undergraduate courses from students domiciled in China, with assumptions of change of +20 per cent, 0 per cent, -20 per cent, -40 per cent in the next 5 years.

23. We will also evaluate the impact of broader, systemic issues on the sector, identifying 'triggers' and modelling their various direct and indirect consequences on providers. For example, the consequences of banks pulling out of the higher education lending market and the effect on necessary future capital development; or multiple provider failures and the likely effect of this on the confidence of sector stakeholders (e.g. lenders, students, staff, pension schemes).

24. We know that the diversity of providers means that no single provider is likely to match our modelling assumptions. The model would therefore prompt assessment and engagement with an individual provider to better understand its financial circumstances. For example, cost reduction may be more or less possible depending on a provider's estate, its delivery models and course content, and its existing financial strength or market strategic strength (its ability to a attract students).

25. This process would not be expected to identify providers that were clearly on the road to financial difficulties: many might be able to achieve a strong financial position subject to certain underlying scenarios. Rather it is to identify those providers that are particularly vulnerable to these risks so that we can test whether their management and governance arrangements, including the capabilities of their boards and senior leaders, are likely to be sufficient to navigate these challenges. This allows us to intervene proactively before a provider reaches a point of financial distress. This is important because it gives us and the provider the maximum latitude to find solutions that protect the interests of students, whereas intervening only when market exit is a material risk leaves a narrower set of regulatory choices and often limited time to deploy them.

26. The experience of the global financial crisis has taught us that it is also (and simply) important to have some understanding of where and how great the stresses are likely to be. This is

particularly important for the OfS as the organisation with a duty to monitor the financial sustainability of higher education providers. While action to manage such risks in advance may not be immediately available to the OfS or to DfE, forewarned is forearmed.

## The intervention approach we propose

27. When the scenario modelling described above has identified those providers most likely to be exposed to significant risk, we can focus our regulatory attention on how they are managing financial risk and the effectiveness of their management and governance arrangements in that context. Steps might include:

    a. Deep dive into a provider's financial strategy and planning, including a focus on:

        i. Capital plans (scope, costs, likely benefits).

        ii. Short term financial planning, particularly cashflow analysis.

        iii. Longer term market strategy – how growth will be achieved, from where, and how this relates to competitors' activities.

    b. Testing and addressing management and governance capability:

        i. Independent or OfS-led review of governance effectiveness, including the capability of structures, systems and people in the context of likely future financial pressures.

        ii. Addressing ineffective governance through interventions targeted in response to compliance concerns, including in relation to conditions E1, E2 and E3.

            - Requirements for specific training to be undertaken.
            - Requirements to accelerate or begin recruitment processes to replace existing governing body members.
            - Appointing independent observers to the Board with a responsibility to report to OfS (or OfS members of staff observing) about ongoing effectiveness.
            - Review of performance management arrangements for a provider's accountable officer, and requirements to take action to improve if necessary.

        iii. Addressing ineffective management through interventions targeted in response to compliance concerns, including in relation to conditions E2 and E3.

            - Consideration of whether a provider's accountable officer continues to be suitable.
            - Review of performance management arrangements for senior staff, and a requirement to improve if necessary.

- Regular engagement with the OfS, reporting in relation to a monitoring and intervention plan.

iv. Engagement with third parties with a shared interest, for example, lenders and other regulators.

28. We have previously adopted elements of this regulatory approach for a small number of providers, but we are now signaling a more systemic and proactive approach than we have generally taken to date. We consider this an appropriate evolution of our regulation of both financial sustainability and management and governance issues. We are, however, aware that deploying OfS resource in this area means that it cannot also be deployed elsewhere, and prioritisation is likely to continue to be necessary.

29. Our proposed approach also sits alongside the action we took during the pandemic to introduce condition C4 (student protection directions). Condition C4 provides a backstop to allow us to direct a provider to take actions to protect the interests of students where there is a material risk of market exit, whereas the more proactive approach set out above seeks to minimise the need to use that backstop on the basis that earlier intervention would better protect the interests of students. We take the view that it is likely to be more effective to intervene before the use of that backstop becomes necessary.

**Recommendation:**

30. The board is invited to provide advice on the development of our approach identifying cases where proactive intervention may be necessary, and the shape of that intervention. It would also be helpful for the board to provide a steer about prioritisation of this activity.

## Risk implications

31. The issues in this paper relate to our monitoring of the financial sustainability of higher education providers and identification of systemic financial risks across the sector. The principal risks the proposals are designed to address are:

   a. An approach to monitoring that responds to the financial information submitted by an individual provider could result in the OfS failing to identify in a timely way financial risks that are created by the external environment, and that are relevant to groups of providers, or the whole sector.

   b. A regulatory strategy that focuses on our ability to intervene at the point where financial failure is reasonably expected for an individual provider leaves us with limited space to protect the interests of students at that provider, and also increases the likelihood of multiple provider failures as a result of the same financial stresses.

## Paper publication date

32. This paper can be published on the OfS website after the board meeting.

## Annex A: Regulatory response to the pandemic

In March 2020, in response to the pandemic, we adjusted our approach to focus on short-term financial risk. We took a series of actions described below:

Modelling and environmental scanning

a. We developed a modelling capability that allowed us to project the unmitigated impact of various financial scenarios, using the detailed financial and student number forecast data that we hold. Impact was considered in relation to income losses, across multiple detailed income streams, and the consequential impact on operating cashflow (i.e. the ability to generate cash from operations for investments) and liquidity (cash holding). We ran various iterations of financial impact scenarios throughout 2020 and 2021, for OfS internal use and also to use collaboratively with DfE and UKRI/Research England. The output from this work shaped the engagement strategy we used to target those providers that presented most cause for concern.

b. We evaluated and monitored the availability of mitigations and support mechanisms for providers, particularly, government support and loan schemes which were and were not available to different types of providers. We also monitored the take-up by providers of government-backed loan support and modelled how much this might theoretically support the income needs in some income loss scenarios.

c. We have always enjoyed a constructive relationship with the main lenders to the sector, including corporate bond investors and credit rating agencies. The frequency of this engagement increased throughout coronavirus pandemic as it was important to understand the views of lenders and their ongoing approach to the sector during this period. This provided invaluable insights into providers' management of risks and the support available. This includes the availability, types and terms of loans available to the sector. We also established an understanding of the approach that lenders were taking to covenant metrics in times when providers' income and financial performance could be adversely impacted by the pandemic.

### Data collection and monitoring of individual providers

a. We revised our reporting requirements for providers, refocusing our 'reportable events' on matters directly relevant to the environment created by the pandemic to minimise the regulatory burden placed on providers. We focused on short-term financial risk and the cessation or suspension of the delivery of higher education. We required a provider to report if it considered it reasonably likely that its liquidity would drop below 30 days at any point during a rolling three-month period, unless this was the provider's normal cash management policy or was mitigated through an agreed revolving credit facility, overdraft or other financing.

b. We extended the deadline for submitting audited financial statements and financial data in anticipation of delays or extended work required at some providers to complete their annual audit, to complete discussions with lenders on covenant compliance, and the additional assurances that may have been necessary to demonstrate going concern.

c. We introduced an additional 'interim' financial return collection in October 2020 to allow us to assess short-term financial risk for all providers. The interim return was a one-off data collection, targeted at a limited but core financial dataset relating to key financial performance, strength and resilience information. Specifically, we sought to understand the impact of the pandemic on a provider's income, cash flow and liquidity, and any changes to its borrowing arrangements. For many providers this was the first time we had a clear comprehensive view of the expected impact of the pandemic on financial performance for their year ending in 2020 and their expectations for 2021. Timed at the end of October 2020, it was sufficiently early to capture cash liquidity risk in 2020-21, while allowing most providers to forecast for the year at a reasonable level of accuracy, informed by recent student registrations and any financial mitigation activities necessary for the coming year.

d. Throughout the recruitment cycle for 2020-21, we monitored trends in applications, offers and acceptances at both sector- and provider-level. UCAS data provided invaluable insights into the recruitment of full-time undergraduate students at providers and we received data more frequently throughout the 2020-21 clearing cycle. A high proportion of international students do not apply through UCAS, but we maintained contact with the British Council to understand trends and forecasts for the movement of international students at a national level and our engagement with individual providers allowed us to monitor international registrations relative to the forecast data in a provider's interim return. We shared intelligence about student recruitment trends with DfE analysts and other sector engagement bodies, such as banks.

## Engagement and intervention

a. Using modelled data, reportable events and the financial information we held for individual providers we took a risk-based approach to engagement. We held meetings with providers' senior staff, in which we discussed scenario planning, short-term financial risk and the mitigations that were in place or likely to be available. In some cases, we held a series of meetings to ensure that we understood the mitigating actions a provider was taking and whether these were credible. It was clear that, generally, providers were taking an appropriate range of steps to mitigate the impact of the pandemic, including arranging borrowing, pausing or reducing planned capital investments, cost cutting exercises and the sale of assets.

## Refining our regulatory tools

a. For a small number of providers, before and during the pandemic, we used our intervention tools to protect students from the effects of a possible market exit. We sought to impose specific conditions of registration to require a provider to design student protection measures and prepare a credible plan to implement them should that become necessary. Our experience was that the statutory consultation period we are required to follow before imposing a specific condition significantly delayed our ability to intervene, such that students remained unprotected. To address this, we consulted on and introduced a new ongoing condition of regulation, condition C4, which allows us to issue student protection directions where we judge there to be a material risk of market exit for a provider. This allows us to intervene to protect students more rapidly in these circumstances.

## Annex B: Examples of recent modelling work on areas of risk or uncertainty

The following describes some of the analytical and data modelling activity we have undertaken recently, in addition to our work on coronavirus. This work is primarily driven by financial risks and potential changes in higher education funding policy.

### Admissions/variations in student numbers

Various data sources support our oversight and assessment of risk during the recruitment cycle and throughout the year, including the following:

a. Student number forecasts, which detail the mode and level of study, and split this by UK, EU and Non-EU. We compare recruitment performance against the latest forecasts to determine whether any change in recruitment performance, positive of negative, was intended by the provider.

b. UCAS data provides information on applications, offers and acceptances. We receive various deliveries of UCAS data at provider level, from results day, through the clearing period. This allows us to draw some, albeit broad, conclusions on provider recruitment performance. UCAS data was received more frequently throughout the 2020-21 clearing cycle.

c. We maintain contact with the British Council to understand trends and forecasts on the movement of overseas students at a national level and our provider engagement allowed us to monitor some trends in overseas student enrolments relative to forecast data from the interim return at a provider level. We have considered the reliance on recruitment from particular countries (e.g. China).

d. SLC withdrawal notifications provide an indication of how many students are leaving their course and we have monitored this to understand any issues which could have financial consequences as well as indicate other systemic concerns at a provider.

### Funding reform, post-18 (Augar) proposals – fees/grant

a. We continue to use the latest data to model fee and funding reform scenarios and the sensitivity of the sector (and trends for particularly parts of the sector) to scenarios such as changes to tuition fee caps, student number controls and grant funding changes.

### Access to/ overreliance on borrowing

a. Borrowing is a significant part of the financial model of the sector to finance capital investments and many developments over recent years would not have been possible without access to relatively cost-efficient borrowing. On the other hand, there is also possibility of over-gearing risk in the sector and it is therefore an area we pay close attention to.

b. We maintain a mutually beneficial relationship with the main lenders to the sector, including private bond investors, and credit rating agencies. We find this dialogue invaluable to understand the availability of debt to the sector for its investment needs. It is also helpful to understand how banks approach the sector on topical issues, such as providers with weaker financial strength, or USS valuation negotiations.

c. Data collection – all borrowing activity – detailed information on borrowing instruments such as type of borrowing, name of lender, length of term, rate and mode of interest, repayment method etc. This allows us to understand borrowing exposure at individual institutions and also to analyse recent borrowing trends, which can fluctuate, such as types of available lending, rates of interest, length of terms, etc.

## Rising cost of pension schemes

a. HE providers and employees participate in many different pension schemes. The sustainability of pension schemes has become an increasing concern for HE providers and for scheme members (employees). This is highlighted starkly by the recent and continued negotiations following recent revaluation of the Universities Superannuation scheme (USS), which has seen significant variation on the value of the scheme deficit.

b. In addition to USS, other schemes are also requiring additional contributions to maintain the sustainability of pension benefits. This includes the Teachers' Pension Scheme. The local government pension scheme is due for revaluation in the near future.

c. In recent years we have begun to collect more granular data on pension contributions and accounting provision adjustments which allow us to understand and present underlying financial data (exclusive of accounting entries for pensions, which can distort some accounting metrics).

d. This data also allows us to model scenarios about future contributions and has been invaluable in understanding the financial implications of the recent and currently proposed USS valuations, and of other schemes.

e. Another topical area currently is the proposal by USS to establish a debt monitoring regime, which includes securitising on a pari pasu basis alongside other debt. This is a significant development which may alter the way that banks and other investors approach the sector.

## Future relationship with the EU

a. Before, during and since the EU referendum we have worked to understand and monitor the key financial implications of a changed relationship with the EU. This includes impacts on the recruitment of EU students and the fee regime that applies to them, and it also impacts the recruitment and retention of world leading academic staff from the EU.

b. We have worked collaboratively with UKRI/Research England to understand the research aspects of English HE's relationship with the EU, including funding (primarily access to the Horizon programme) and collaboration activities.

c. European Investment Bank (EIB) involvement in providers. We have looked at the implications for existing EIB borrowers, and also for the wider impact on less availability of EIB borrowings.