The financial health of the Higher Education sector

2011

Contents

Introduction

This year's report on the financial health of our universities comes at a time of unprecedented challenges facing the Higher Education ('HE') Sector. Government policy is driven by the need to reduce the deficit in the nation's finances and universities will be affected as the reduction in state funding materialises.

The HE sector makes a varied and diverse contribution to the UK economy including:

- total turnover is £26.4 billion and the sector directly employs some 130,000 people
- playing a vital role in improving the qualifications and skills base of the UK workforce
- carrying out research activities that act as a spur to innovation, improving knowledge and techniques, which enhance the UK knowledge base.

Our review of the financial statements of universities shows that the financial position of many universities has improved for the year 2009/10. Overall surpluses in the sector totalled £811 million compared to £345 million in the previous year.

The improved financial results arise principally from increases in tuition fee income, both home and overseas, as well as achieving improved control of salary costs. This position will help the sector respond to the challenges arising from the Government's proposed funding changes. However the position is variable with some 26 universities recording deficits (including exceptional items) and with 79 (49%) universities not achieving HEFCE's minimum recommended surplus of 3%.

Key challenges arise from:

- income from Funding Council grants has been a significant source of income [35% in 2009/10] and will reduce dramatically from 2012/13 as funding shifts from Government to the student for home and EU undergraduates
- threats to overseas student income arising from the restrictions on tier four visas as well as increasing international and domestic competition
- overall the market for attracting students will be more competitive arising from level of fees, quality and the alternatives to university degree accreditation.

In financial terms, universities will need to continue to look carefully at their cost base. The main question is how can costs be reduced while still retaining a world class system of Higher Education? Our report draws attention to a new operating model for universities going forward. Over half the costs of running a university relate to people costs and less than 45% of those staff costs deliver that world class system as lecturers and researchers. We consider how adopting the concept of shared services for back office costs can put the delivery of higher education on a more efficient basis which does not compromise academic and research excellence.

Finally we consider the implications of the proposed changes to tuition fees and their repayment to students and the impact these may have on student recruitment. Broadly the new system is progressive, as repayment of fees is by and large based on ability to pay. However we draw attention to:

- some areas where the proposed system will give a result that is not progressive
- the potential for the level of student debt to put off students from poorer backgrounds pursuing a university education
- the 'squeezed middle' of post graduate earners where the 9% repayment levy will effectively last for 30 years and, when combined with tax, national insurance and pension contributions as well as housing costs, will leave very little disposable income
- the lower financial benefits arising from a university education than previously could be expected.

We hope that you will find this edition of the Grant Thornton analysis of the financial health of the Higher Education sector informative and helpful.

Contribution to the UK economy

The HE sector makes a varied and diverse contribution to the UK economy. The total turnover of the HE sector in 2010 amounted to £26.4 billion and directly employed some 130,000 people.

The real value and long term benefit of the development and training of students is to be able to fulfil their potential and allow them to contribute to the value of the economy.

Higher wages and better employment prospects raise the quality and quantity of the skills base in the UK, improving productivity. Wider economic benefits flow from enhanced educational outcomes for students, in particular, from the additional income earned by individuals over their lifetime as a result of them being better qualified.

In addition, the research activities of the universities act as a spur to innovation, improving knowledge and techniques, which spill over into the UK knowledge base.

UK economic prospects

The UK economy is no longer in recession but is finding it hard to shake off the effects of the global financial crisis. The economy enjoyed fairly buoyant GDP growth last year of 0.8% in Q3 2010 on top of 1.2% in Q2 2010, but over the past six months there has been no economic growth. The impact of the Government's austerity measures, has depressed business and consumer confidence and reduced economic activity across most sectors and regions of the UK.

The prosperity of the UK economy over the next few years will be critical for the financial health of the HE sector, both directly and indirectly. Interest rates will directly impact on the ability of universities to meet debt repayments and a significant rise could easily put a few institutions over the edge.

The Bank of England base rate has remained at an historic low of 0.5% since February 2009. Consumer Price Index (CPI) at 4.2% in June 2011 is well above the Bank of England's target rate of 2% and is expected to remain so for the rest of 2011. Rising oil prices, the cost of imports and the VAT increase have all added to the pressures on inflation.

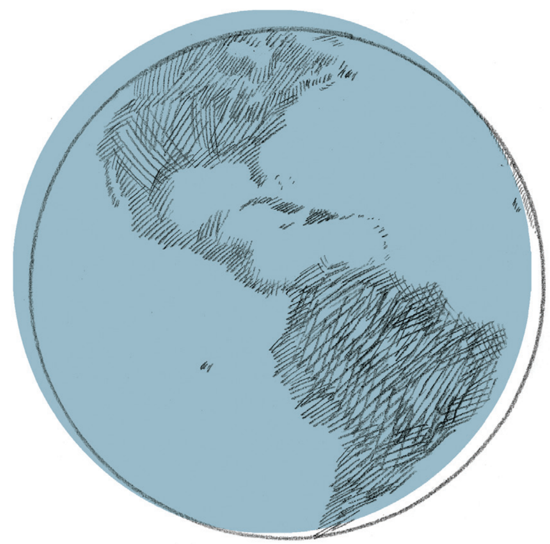
So far, the drivers of inflation have largely been temporary factors, but there is now a real and escalating risk that above target inflation may become embedded in expectations feeding back into wages. This has not happened yet, but this is a danger that the Bank of England will want to avoid. Grant Thornton expects interest rates to start to rise in 2011, gradually increasing to 2% by the middle of 2012.

Public finances

There are many uncertainties going forward. The current plans to address the deficit will have an indirect impact on the HE sector.

How quickly the UK economy recovers will impact on the Government's plans to address the deficit and in turn the funding of the HE sector. The HE sector is due to face significant budgetary changes in coming years as public sector funding is reduced and replaced to a significant level, by funding from individuals, through tuition fees. A 40% or £2.9 billion reduction in the overall resource budget for HE (excluding research funding) by 2014/15 was announced in the 2010 Spending Review.

A return to slow growth is expected during 2011 and a recovery back towards trend growth by 2.5% towards the middle of 2012. It is not yet clear how the move to higher tuition fees will impact on individual universities, but it is clear that in the next few years, all are likely to face greater risk and uncertainty over their income.



HE Sector financial performance in 2009/10 - Summary of findings

Overall, the HE sector (155 Higher Education Institutions (HEI) analysed) strengthened its financial position significantly in 2009-10 which will help it face the significant future financial challenges arising from the Government's proposed funding changes.

The sector generated surpluses of £811 million in 2009-10 compared to £345 million in 2008-09, driven mainly by increases in tuition fee income from home and overseas whilst HEIs maintained control of their wage costs.

The number of HEIs in deficit decreased in the year and most of these deficits only arose because they had incurred exceptional restructuring costs, suggesting they took action to strengthen their future finances.

One fifth (26) HEIs incurred a deficit in 2009-10 compared to 33 in 2008-09. Without exceptional costs the number in deficit would have been only seven HEIs.

There has been a significant increase in those institutions which achieve in excess of HEFCEs minimum recommended surplus of 3% of income, although a significant minority still do not achieve this guideline figure.

Some 49% (79) HEIs are still not generating surpluses above the recommended minimum of 3%, despite the overall increase in surpluses across the sector.

HEIs grew their income well above inflation in 2009-10 with increases in home and overseas tuition fee income being the most significant. Tuition fee income is now just below the level of funding council income received by the sector.

Home and overseas tuition fee income grew by over 20% in 2009-10 with overseas student fee income now worth £2.4 billion to the sector, representing 8% of total sector income.

Staff costs rose in 2009-10 but not as much as the increase in income, suggesting that HEIs are controlling staffing and salary levels.

Staff costs increased by 4% in 2009-10 but nearly all HEIs have staff costs as a proportion of income below the level of HEFCEs indicator of 'potential concern' of 64%.

Borrowings as a proportion of income have declined in 2009-10 showing that HEIs have not been keen to extend their borrowings or have been using existing cash balances to fund capital developments.

In 2009-10, borrowings only increased by £95 million across the sector and now stand at 18.7% of income compared to 19.5% last year. HEFCE considers that HEIs should keep the costs of servicing borrowing below 4% of their income. All but 12 HEIs managed to achieve this position in 2009-10.

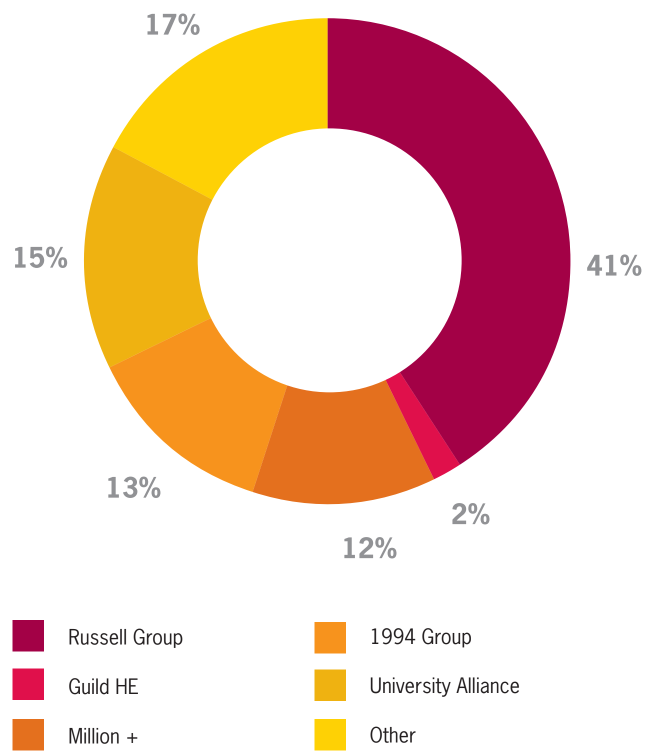
The liquidity of the sector (ie easily available cash balances) improved slightly during the year which is to be expected given the increase in surpluses.

The liquidity ratio (quick ratio) increased to 1.34 in 2009-10 from 1.3 in the previous year. This indicates that the sector has an improved level of working capital available for funding operations.

Analysis of the data

We have undertaken an analysis of the published accounts prepared by all UK Higher Education Institutions for the financial year 2009/10. We have extracted selected financial information and calculated indicative financial ratios as appropriate.

We have also looked at the data aggregated within the various HE Mission Groups. Across the HE Sector, the relative size (by income) of the various mission groups is as follows:



Data was not available at the time of preparation for the following institutions which are therefore excluded from the analyses:

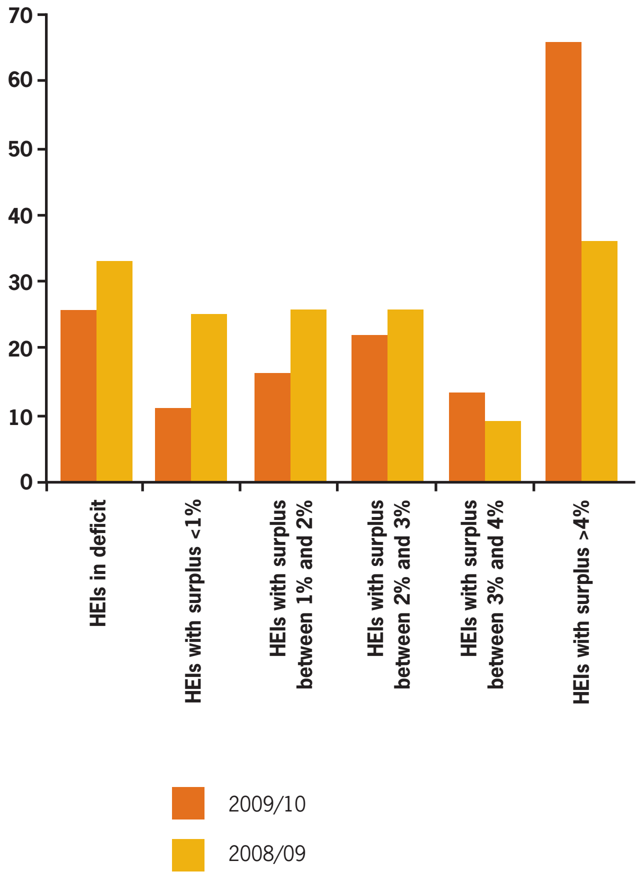
Edinburgh College of Art, Trinity College Carmarthen, University College Plymouth St Mark and St John, University of Glamorgan and Conservatoire of Dance and Drama.

'Profitability' of the HE Sector

In the financial year 2009/10, the HE sector (155 HEIs analysed) generated a total surplus (before exceptional items) of £810.7 million, representing 3.1% of income. This is a significant increase on the previous year, being nearly two and a half times the £345.3 million (1.4% of income) generated in 2008/09.

The increase in the level of surplus was distributed across the sector. In 2008/09, 33 institutions (21.3%) incurred a deficit, whilst only 45 (29%) generated a surplus larger than the HEFCE recommended minimum of 3%. For 2009/10, the number of institutions recording a deficit had decreased to 26 (16.9% of those measured), whilst 79 institutions (51.3%) generated a surplus of 3% or more. In considering these findings it is important to consider the impact of restructuring costs, which are considered further below.

Distribution of surplus by institution 2009/10 vs. 2008/09

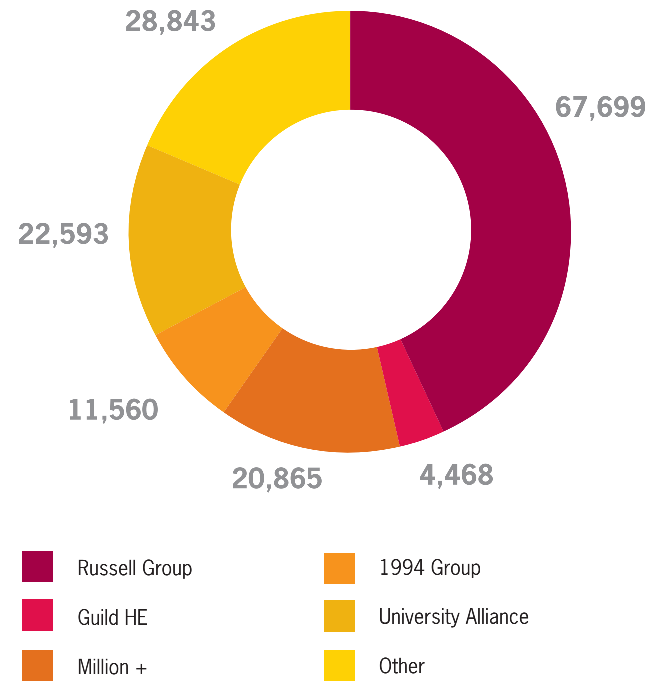


For the various mission groups, the distribution of the generation of surplus was as follows:

Mission Group	Surplus 2009/10		Surplus 2008/09		Growth
	£m	% Income	£m	% Income	%
Russell Group	324.3	3.0%	121.3	1.2%	167%
Guild HE	39.3	6.1%	9.6	1.7%	309%
1994 Group	74.4	2.2%	66.8	2.1%	11.3%
Million +	95.4	2.9%	29.1	1.0%	228%
University Alliance	135.2	3.5%	60.2	1.7%	125%

The reported surpluses and deficits over the past two years have, in a number of cases, been influenced by the costs of restructuring which have been incurred to improve efficiencies. In 2009/10, UK universities spent over £157 million on restructuring costs, with the Russell Group institutions spending by far the largest proportion (44.0% of the total sector spend).

Across the various mission groups, restructuring expenditure was as follows:



If the costs of restructuring were to be discounted, seven of the 26 institutions that recorded a deficit in 2009/10 would have been in surplus during the year.

Generation of Income

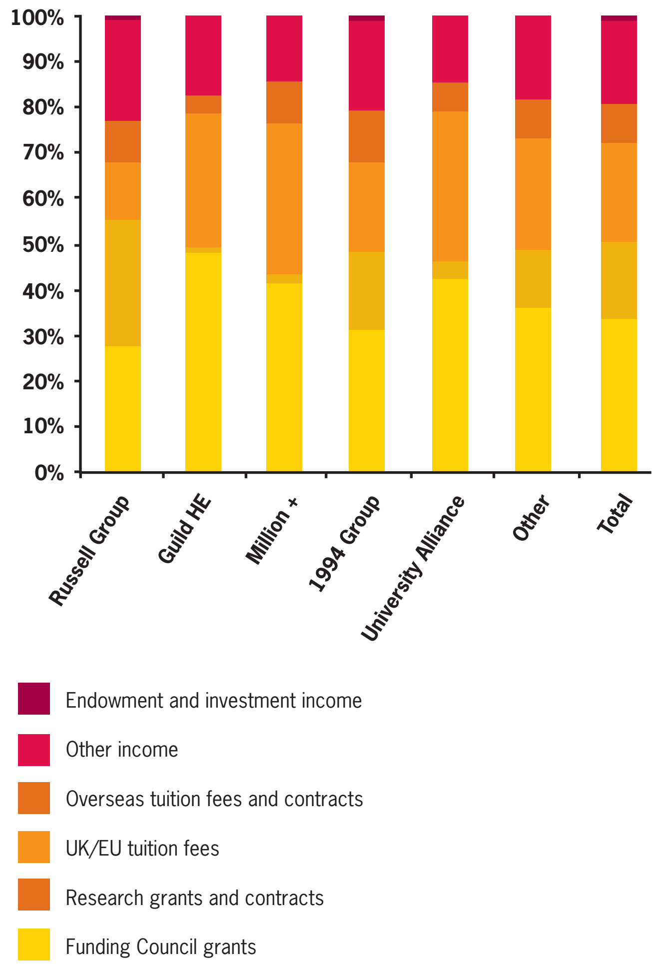
The sector generated income of £26.4 billion in 2009/10, which represents an increase over the previous year of £24.9 billion, or 6.1%.

The following table shows the distribution of each source of income between mission groups.

Sources of income 2009-10

The following table shows the distribution of income between the different mission groups.

Sources of income 2009-10



An analysis of income sources shows that:

- Income from Funding Council grants of £8.9 billion is still the single largest source of income, representing 33.7% of the sector total. This amount is 3.3% greater than in the previous year, although it represents a smaller proportion of the total (Funding Council grants were £8.6 billion in 2008/09, 34.6% of the sector's income).
- UK tuition fees and contracts income was £5.8 billion representing 21.8% of the total income in 2009/10. This represents a 12.3% increase from the previous year (£5.1 billion, 20.5% of the total).
- Research, grants and contracts have increased to £4.4 billion, up by 5.1% from £4.2 billion last year, and represent 16.6% of the sector's funding, marginally below last year's figure of 16.7%.
- Tuition fee income from overseas students continued to grow, and was worth £2.4 billion to the sector in 2009/10. This represented 9% of total income, and showed a growth of 18.1% on the previous year's figure of £2.0 billion, which was worth 8.1% of total income.
- Other income (which includes fees in respect of residential income as well as other income streams) accounted for £4.8 billion, or 18% of total income. This was up by 2.5% from the previous year, when it was worth £4.7 billion, or 18.7% of total income.
- Income from investments and endowments fell from £353 million (1.4% of the total) in 2008/09 to £216 million in 2009/10 (0.8% of total income).

The analysis between mission groups shows some expected variances in the sources of income. Russell Group universities have a more diversified income portfolio with research and contract income being a much larger proportion of the overall total than other groups.

Overseas tuition fee income represents an important income stream for the sector, being worth £2.4 billion in 2009/10.

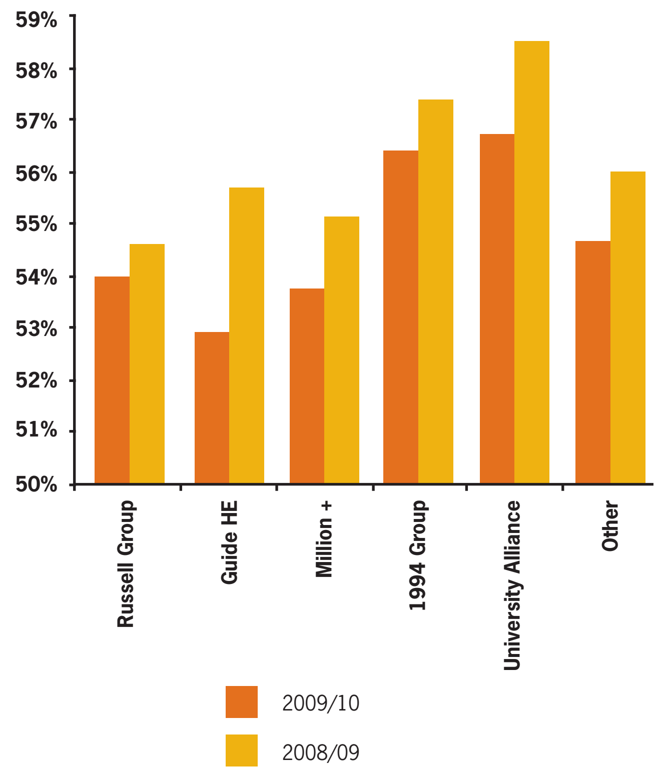
However, although more than 40% of the sector's overseas income was generated by the Russell Group – broadly in proportion to its overall financial position in the sector, that income represented only 9% of the total Russell Group income. Overseas income for the 1994 Group members was relatively more important, at nearly 12% of their total income.

Staff costs

The principal cost of any institution is the cost of employing staff. For 2009/10, total staff costs (including NI and pension contributions) are £14.5 billion, or 54.7% of income. This represents an increase on last year of £13.9 billion (4.0%), although it is a reduction in the percentage to income (down from 55.8%).

Across the different mission groups, staff costs varied slightly, from 52.9% of income (GuildHE) to 56.7% (University Alliance). Looking across the two years, all mission groups demonstrated a reduction in staff costs as a percentage of income, with that of GuildHE (from 55.7% to 52.9%) being most pronounced.

Staff costs as % of income 2009/10

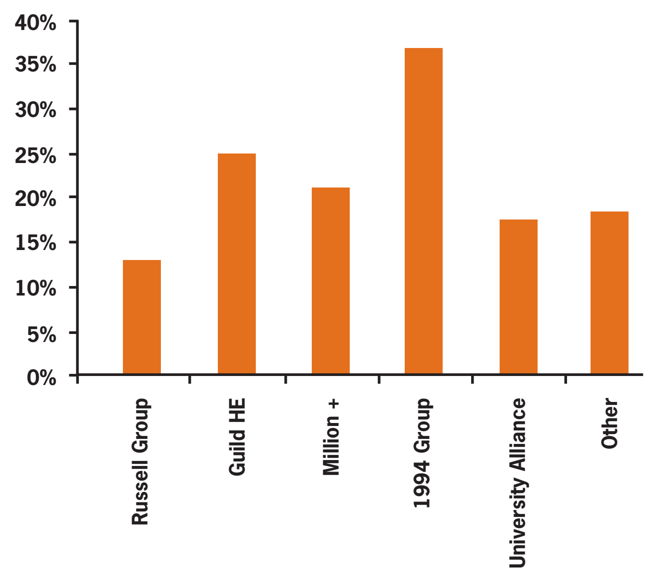


Borrowing and Interest

Total borrowing for the sector at the end of July 2010 amounted to £4.946 million, up by £95 million or 1.9% from the previous year's figure of £4,851 million.

Across the sector, this level of borrowing represented 18.7% of income, slightly less than the equivalent figure for last year of 19.5%. However, across the sector the level of borrowing as a percentage of income varied greatly between the different groups. The Russell Group showed the lowest percentage, at just under 13%, whilst the 1994 Group were significantly the highest, with borrowings representing 36.9% of income.

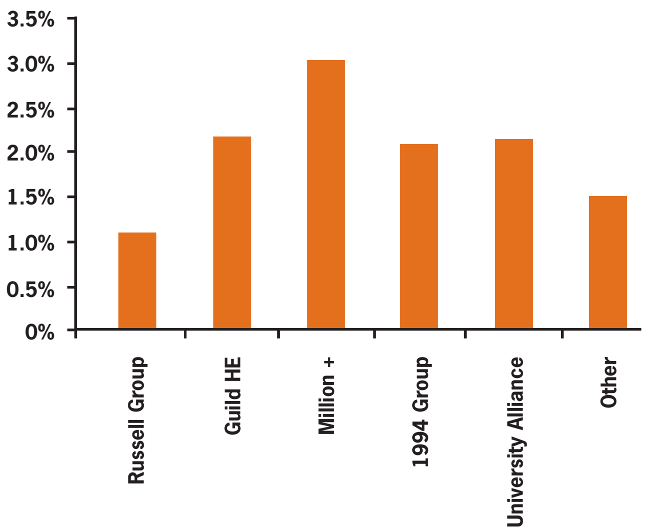
Borrowing as % of income 2009/10



Interest costs

Possibly more important than the absolute level of borrowing is the ability of the sector to service its borrowing. In 2009/10, the interest cost to the sector of that borrowing was £446 million, or 1.7% of income. This cost varied across the mission groups, from just over 1% for Russell Group institutions to over 3% for the members of Million+ as shown in the table below.

Interest costs as % of income 2009/10



HEFCE requirements are that institutions should seek permission for additional borrowing if the cost of servicing its existing loans is greater than 4% of income, and this threshold is another of the benchmarks used to highlight areas of potential concern.

12 institutions fell into this category in 2009/10, and a further 18 institutions had interest costs that were between 3% and 4% of income.

Liquidity and Gearing

Quick ratio

The quick ratio is a measure of an organisation's short-term liquidity, and measures its ability to meet short-term obligations. It is calculated as the ratio of current assets (excluding inventories) to current liabilities.

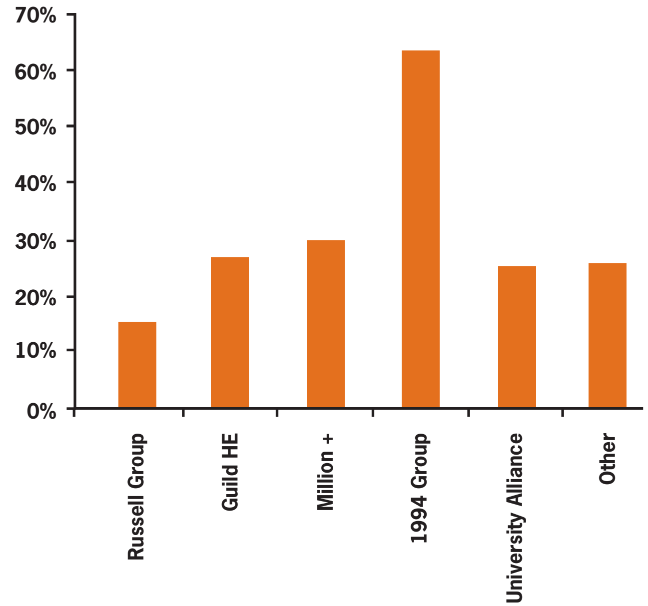
The overall quick ratio for the sector in 2009/10 was 1.34, compared to a comparable figure for the previous year of 1.3, indicating a slight improvement in short term liquidity.

Of more concern, however, was that 34 institutions had a ratio of less than 1.0, indicating that they were not currently in a position to pay back their current liabilities. The number of institutions in this position remains unchanged from the previous year.

Gearing

The gearing (also called leverage) of an organisation is the ratio of debt funding to internal reserves. There is no 'recommended' value of this ratio, but it is accepted that those organisations with higher gearing are likely to be more vulnerable to downturns. The average gearing for the sector in 2009/10 was 24.9%.

Across the mission groups, the gearing varied widely, from just over 15% for the Russell Group to 63% for the 1994 Group.



There were 12 institutions where the gearing ratio was greater than 100%.

The future of the HE sector

It is now clear that the HE sector, envisaged by the White Paper 'Students at the Heart of the System' will be significantly different from that we have experienced to date. Not only will institutions be encouraged to compete, both on the basis of performance (student experience, outcomes and price), but the barriers to new competition from Further Education colleges and private institutions will be lowered.

Added to that, the existing mechanism of controlling student numbers is to be discarded and replaced with a much more 'free for all' approach that offers the prospect of much more flexibility in recruitment. That flexibility, of course, will work in both directions, and more than ever before, HEIs will be responsible for their own destiny.

The report from HEFCE (Financial Health of the Higher Education Sector, March 2011) concludes:

'Overall the financial health of the sector remains sound. However this will come under greater pressure during the next few years as the reductions in public funding following last autumn's spending review are implemented. Higher education institutions are entering a period of transition to a new financial settlement from a position of financial strength, though there will undoubtedly be significant challenges ahead'.

This view is supported and enlarged upon by the National Audit Office: (Regulating financial sustainability in higher education, March 2011)

'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.'

Our own view is that the impact of the changes will be far from consistent across the sector, and that despite the sector as a whole being currently in a strong financial position, a number of institutions may, due to a number of different factors such as their financial structure, their position in the market, or their reliance on certain income streams, find themselves very much more vulnerable than others.

In coming to this view we have speculated on the amount and type of change that may occur, and have attempted to predict how these changes may impact on different types of institutions.

The scenarios:

Student numbers (UK and EU)

One of the key unknown variables at the current time is what changes will occur to the number of students applying for university places. Although currently there are applications in excess of available places, informed opinion is that student numbers may fall between 10% and 15% over the next three to four years. Current year applications are up, ahead of the increase in tuition fees, but it is possible that numbers will fall thereafter as the higher level of fees discourages students.

There may also be some impact felt at English institutions if students look at the provision of education that is available overseas, for example in Europe, Australia or the USA.

The introduction of higher tuition fees may also have the effect of encouraging more part-time students, and, due to the equalisation of loan availability for part time students, we expect the level of part time students to proportionally increase compared with those studying on a full time basis.

One of the positive impacts of the introduction of tuition fees is likely to be an increase in the retention rates experienced by institutions, as students become more aware of the importance of completing their degree courses. This would have the benefit of partially offsetting any decrease in the overall reduction of student numbers that may occur.

It is our view that these changes will not impact consistently across the sector. The benefits and otherwise of widening participation are beyond the scope of this analysis, but pragmatically we would not expect to see the Russell Group institutions significantly impacted, nor would we anticipate that the smaller, specialist institutions would experience the full level of the downturn in student demand.

Our view is that it will be the 'squeezed middle' rank of universities who will be most likely to be affected by the reduction in student numbers. These institutions depend more heavily on students from the local region, and may not attract students on a national scale, particularly if they are unable to offer any specific differentiation from other institutions in the sector. They are likely to find themselves in a more competitive market, i.e. those students who may feel less inclined to go to university if they can obtain the necessary qualification to give them their ticket to employment, without having to incur the costs (even if they are deferred) of doing this through the more traditional university route.

The final factor to take into account in determining student demand is the growth of the private universities, and other providers of Higher Education (Further Education colleges for example). The rise in tuition fees will start to make these organisations increasingly competitive and attractive to students, and the White Paper makes specific reference to encouraging these providers. We do not believe it to be an unreasonable expectation that we will see increasing numbers of potential students choosing to take the private option, at the expense of the traditional universities.

Funding Council Grants

The White Paper promises that direct funding to Higher Education (via HEFCE) will total some £3.9 billion in 2014/15. This represents a reduction of about 40% on the £6.5 billion total funding available for 2011/12.

Whatever the level of direct funding available, it is apparent that any remaining teaching grant will be very specifically directed – to Medicine, Science and Engineering; to strategically important subjects; to widening participation and to the smaller music and arts conservatoires.

Overseas income

Income from overseas students has become an important element of university funding, worth nearly £2.5 billion, or nearly 10% of the sector's total income. The main risk here is that tighter rules on student visas could significantly impact this income stream. The Higher Education Policy Institute has forecast that the proposed restrictions on tier four visas could cost universities some £1 billion (a reduction of nearly 40%) in overseas fee income, although our view is that this level of loss is unlikely to materialise in practice.

More than a third of overseas students in 2009/10 were from either China or India. With the development of those economies, and the continuing efforts being made to achieve world class ranking for their own universities, we expect that more students will complete their education locally rather than in the UK, although it is difficult to predict a likely time frame for this. Whilst we recognise that this is likely to be a factor in the medium to longer term rather than the short time horizon we are considering in this report, it is a potential risk that all universities relying on overseas income should consider and plan for.

The impact of stricter visa controls will impact the sector across the board, although we consider it likely that the cachet of a degree from a world-class university will mean that the Russell Group institutions will be more insulated than others from reductions in total overseas student numbers.

Research funding

Other changes that will impact the sector will include a reduction in research funding, with not just the reduction in total value being relevant, but also in the allocation of this funding.

We believe that reductions in research funding, both from the Funding agencies and from the Research Councils and other bodies such as charities, will fall almost completely on the non-research based universities. Future research funding is likely to be concentrated almost exclusively in those institutions comprising the Russell Group and the 1994 Group. As a result we forecast that research income elsewhere in the sector, although relatively unimportant, will reduce to almost nothing.

Tuition fees

Most universities have declared that they will be charging the £9,000 maximum or an amount close to it, with the appropriate bursary structure in place to meet the widening participation requirements with only a handful choosing to charge significantly lower fees. These levels have been struck as there seems to be a consensus of opinion that to charge less than the maximum would send the wrong signals about quality, and that the easier decision (or the decision that is likely to be 'less wrong') would be to charge the full amount. However, whatever the level settled on, the range of pricing, through bursaries, incentives and payment schemes that will be introduced to attract as many students as possible, will make the options for students undoubtedly far more complex than currently. This will be made even more complex for students with the introduction proposed by the Government to increase competition within the sector through 20,000 places being made available for those institutions (including Further Education colleges) who will charge less than £7,500.

Our opinion is that whilst we accept that tuition fees within the Russell Group and 1994 group will probably continue to be set at the full amount of £9,000, other universities who find themselves recruiting students in a more competitive environment will need to consider carefully the price point at which they set their fee levels, and be prepared to be reactive to the market as the pricing strategies of other universities unfold in subsequent years.

The implications

We have not attempted to carry out detailed modelling of the implications of the above scenarios as the variations and impact on different classes of universities would be difficult to assess with any certainty.

We have, however, attempted to assess the likely impact on a typical 'squeezed middle' university, with income of some £170 million, payroll at 56% and a surplus on 2009/10 of some 2%, as it is this type of university that in our view is likely to be the most vulnerable to the income changes that may arise.

Our analysis has assumed the following:

- tuition fees are set at £7,200 (assumed to be net of bursaries)
- teaching grants decrease by 30% per annum after July 2012
- research income is reduced by 10% per annum as a result of the concentration into the Russell and 1994 Group universities of the reduced funding available
- the impact of the new tuition fees results in a reduction in student demand for university places. We have assumed a one off reduction of 20% in 2012/13
- that there is a one off reduction in overseas income of 30% in 2012/13, to reflect the introduction of the impact of the new visa regime (we recognise that this could occur earlier and potentially be more significant).

On this basis, the impact would be a reduction in the annual income of some 11% (£19 million) in 2013/14. In our view the level of tuition fees as assumed above might be higher than universities may change in the future, and the expected decline in student numbers may be greater or more protracted than our projection. Consequently the likely impact may be significantly worse than our estimate above.

There is no easy solution to deal with this shortfall in income. All universities will need to look to reduce their costs (both pay and non pay), ensuring they understand the value of different courses offered and the demand for those courses by students. Brand awareness in its wider sense will become critical to all universities in the future.

In addition we would suggest that universities look to new operating models to ensure their sustainability, which may be fundamentally different from those currently employed.

A new operating model for the sector

The future of Higher Education in the UK has been discussed at length in the press in recent months, with the recent White Paper at least allowing institutions to understand the shape of the 'pitch they are playing on'. There is now little doubt that there will be a fundamental shift in both the level and source of the future funding into the sector, and that this shift will have a potentially seismic impact on it.

Higher Education in the UK is recognised as being a world-class system, and there is no argument that the contribution made by HE to UK plc is significant, both in terms of the direct benefit to the domestic economy and as a source of foreign income, leaving aside the less easily quantifiable advantages that having such a world-class education provides.

What makes Higher Education a target for cuts is that the cost of providing such a world class system is significant. In 2009/10, the aggregate direct operating cost of operating the combined universities of the UK was more than £25 billion.

Of that amount, over £14 billion was the cost of the people who work in universities. However, less than 45% of those staff constituted what the business gurus might call the 'unique selling proposition' of UK universities, namely the lecturers and the researchers who are responsible for the delivery of that world-class system. The rest was spent upon the infrastructure and the support functions that allow those lecturers and researchers to carry out their tasks. That is not to say that those supporting functions and the infrastructure are unimportant, but they are not unique (with possibly some exceptions), nor are they the reason for the world class ranking of UK universities.

It is this analysis that suggests how the Government targeted cuts could be absorbed by putting the delivery of higher education on a more efficient basis that doesn't compromise the academic teaching and research capability that constitutes the heart of the academy - but in cost terms might account for less than 50% of the cost of operation.

The concept of shared services is nothing new and has been used in the commercial and public sectors in the UK for some time, although the rather Jekyll and Hyde approach of the UK Government to the VAT issue has possibly inhibited its adoption in Higher Education, although the recent White Paper signals that the Government is finally going to address this issue.

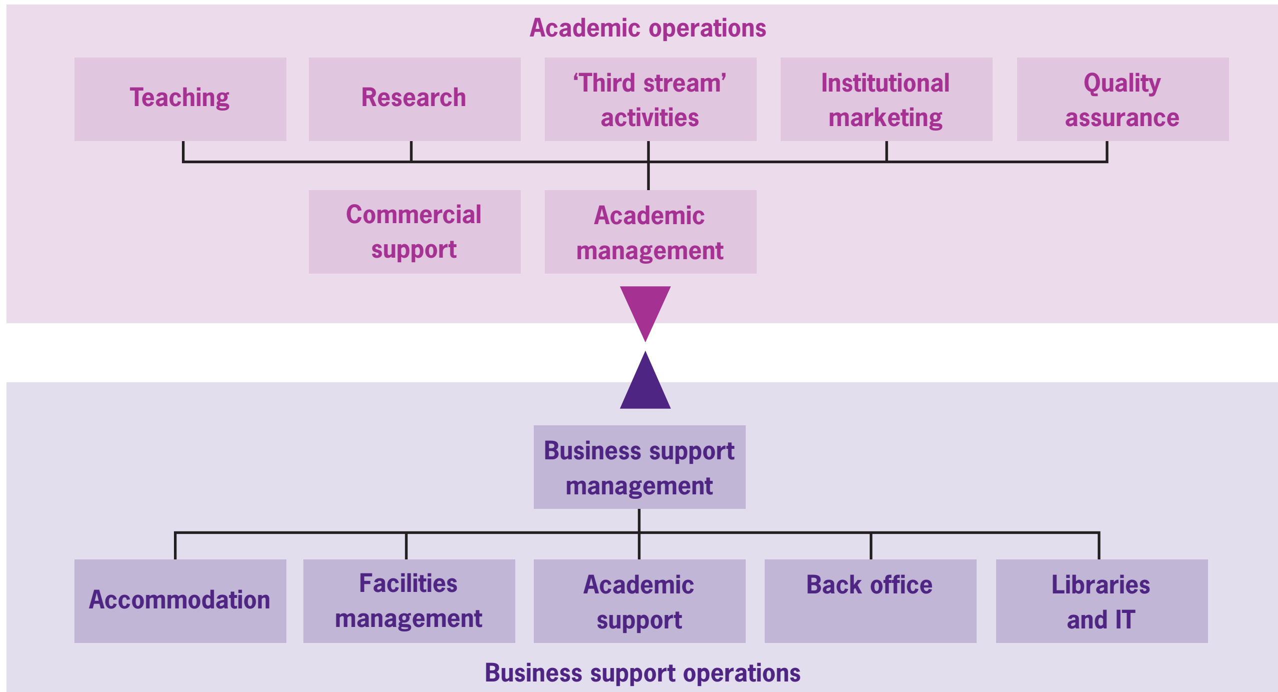
Neither is the use of third party provision of certain services revolutionary, with many institutions now buying services such as facilities management and student residency from third parties.

Taking these trends further, we suggest that rather than 'pick off' the functions that can be shared or outsourced, a new approach would be to identify only those areas of the university function that are involved in those parts of the Higher Education delivery of provision that are unique to the individual institution, and seek to have all of the other functions delivered externally.

There has been much debate about how a more business-aligned model could be applied to universities. Separation of the 'Academic operation' from its administrative and infrastructure support functions could allow the introduction of business practice into the areas where it is most suited and has proven effectiveness. And using a shared service provider to deliver those functions could enable the achievement of the kind of economies of scale that would relieve the cost pressure on the whole institution.

Such a university could look and feel (as far as the student, the commissioner of research, or even the member of academic staff were concerned) very similar to the way it does today.

The academic operation, managed by academics (with some commercial support), would be the university – recruiting and teaching students, interacting with the community, and undertaking research. That university would buy-in all of its infrastructure and administrative requirements – from finance and registry functions to the use of lecture theatres, laboratories and offices – from a third party provider specialising in the management and delivery of such services. It would provide those services under service level agreements overseen by a joint academic/business support team.



It would be naive to suggest that the development of such an organisational model would be straightforward, and there would be many issues that would need to be resolved as to how the elements would fit together.

However, in circumstances where it is likely that the level of spending cuts could be great enough to threaten the existence of more than a few institutions, and seriously compromise the level of HE provision in others, a model that offers the opportunity to achieve cost efficiencies but leaves the unique aspects of the academy in place is worth consideration.

The impact of tuition fees on students

With a growing number of universities confirming that they are planning to charge the maximum £9,000 per year tuition fee, we have looked at the potential financial impact on students, both during their time at university and, after graduation, over their working life.

For a three year undergraduate degree with fees of £9,000 per year and a maintenance loan of say £3,750 per year, a student can reasonably expect to finish his studies with an accumulated debt of around £40,000.

A £40,000 debt is a daunting prospect for any 21 year old, but particularly to those from lower income families, who are not immune from this level of debt because the tuition fee element is not means tested. These students are more likely to be unused to the concept of debt and their aspirations of, and confidence in, earning the sort of salary necessary to ever pay it off, might be lower than that of their peers. This is likely to be particularly the case in today's job market with record numbers of unemployed 18 to 24 year olds being reported in the news. The fear of debt, as well as the debt itself, is a problem, and it is important to consider how, if institutions start to generate different prices for different degrees from different universities, students from lower income families may respond. Will they make a decision about their future based on quality and content, or based on price?

Of course, what students need to consider when making their life choices about which institution to attend and what to study, **is that many of them will never repay their debt.** Browne estimated, under his proposals, that only the top 40% of earners on average would pay back all the charges (the outstanding balance being written off by the Government after 30 years).

What students need to understand is that, if their future career means they are likely to be in an income bracket which will never repay the loan, the amount they repay over their working life will depend on what they earn and not what tuition fee their university charged. Potentially, if a student is thinking of choosing a career with low earnings potential, she may as well go to a university charging £9,000 per year as go to one charging £6,000 per year. What she repays for her education could be exactly the same.

To illustrate this point we have considered three examples from a theoretical 'student class of 2015'. We have assumed that all three students study for a three year Bachelor of Arts degree at a prestigious university which charges the maximum fee of £9,000 per annum. We have also assumed they receive a maintenance loan of £3,750 per year and they all graduate aged 21 years old with a debt of around £40,000. The only difference in their situations is their chosen careers: one goes on to be a corporate lawyer, one a journalist, and one a civil servant.

Leo, Corporate Lawyer (highest earner)

Leo graduates aged 21 with a debt of about £40,000 and, having secured a training contract with a 'magic circle' law firm, he goes to law school for two years. His future employer pays his law school fees and also provides him with a maintenance grant. Aged 23 Leo begins work at the law firm earning £38,000 in his first year of training, £43,200 in his second year of training, before his salary rises to £61,500 in the following year when he becomes a qualified solicitor. Assuming fairly modest rises in his salary of 5% per annum thereafter, Leo would have:

- earned a total of £3.2 million by the time he is 50
- repaid the debt by the time he is 38
- made average monthly repayments of £375
- repaid a total of £68,000 (the initial £40,000 capital and £28,000 in interest).

Janet, Journalist (lowest earner)

Janet also graduates with a debt of approximately £40,000 aged 21. Following graduation she studies for a Master of Arts (MA) in Journalism with tuition fees of £7,000. Without state funding available for her MA, Janet relies on a combination of parental support and income earned through part time work to pay the tuition fees for her MA and to meet her living costs. Aged 22 she starts work earning a salary of £28,000, which rises by 3.5% per annum thereafter. In this scenario, Janet would have:

- earned a total of £1.4 million by the time she is 50
- made average monthly repayments of £120
- repaid about £42,000. She would never repay her debt, because of the substantial compound interest. After 30 years the outstanding debt would be written off by the Government.

More importantly, even if Janet had studied at a university charging fees of £5,000 a year, and had the exact same career profile, she would have repaid exactly the same amount. The only difference would be the amount the Government would have to write off after 30 years.

Tom, Civil Servant (middle earner)

Like his classmates, Tom also graduates with a debt of approximately £40,000. He joins the UK civil service working for a central Government department, without the need for any postgraduate study. His starting salary is £25,000, which rises by 3.5% per annum thereafter. He is promoted to a managerial role aged 27, and his salary increases to £45,000, rising by 3.5% per annum. He is promoted to the senior civil service aged 34 and his salary increases to £70,000. Assuming rises in salary of 3.5% per annum thereafter, Tom would have:

- earned a total of £2.1 million by the time he is 50
- repaid the debt by the time he is 50
- made average monthly repayments of £280
- repaid a total of £98,000 (the initial £40,000 capital and £58,000 in interest).

The changes to student finance have been described as 'relatively progressive' and the case studies above illustrate that there is truth in this statement. By the time they are 50, corporate lawyer Leo has earned 130% more than Janet (our lowest earner) but Leo repays 62% more than her (£68,000 compared to her £42,000).

However the case studies also show that the so-called 'squeezed middle' is on track for further compression. Tom, the middle earner in the case studies, has earned 34% less than Leo by the time they are 50 but he repays £30,000 more towards his student debt. The reason being that, because he earns less, Tom's loan repayments are lower, so it takes him longer to repay his debt. He therefore incurs more interest that has to be repaid on top of the initial debt of £40,000.

Of course the richest tiers of society will be even better off. It will still be possible to pay university fees up front in order to avoid accruing any debt; an option that some parents may take to avoid their children being burdened with debt at the threshold of their adult lives. When you consider that many of these parents may have been paying private school fees of approximately £10,000 to £16,000[1] a year, £9,000 a year to study at Oxbridge begins to sound good value.

In addition, it is important to consider that for some professions, such as law in one of the case studies, the necessary training does not stop after an undergraduate degree. Students may need to support themselves for additional years of study, often without access to any state funding. For students with parents who are unable, or unwilling, to offer additional financial support in this type of situation, the student's choice is between taking on a significant amount of part-time work, taking out additional debt under more commercial terms (for example through a career development loan), or, perhaps more commonly, to decide on a different career path altogether, one which starts paying a salary straight away. For example, some large accountancy firms offer school leavers the possibility to go straight into work and study for an accountancy qualification, giving them the option to bypass university altogether.

The changes, in theory at least, make access to university 'free at the point of entry' as repayment of loans only begins on entry to employment. But the financial cost of going to university is two fold: the cost of living must be considered alongside the cost of tuition. Whilst the 'free at the point of entry' statement is true for the tuition fee element of the cost, the extent to which it is true for the cost of living is less clear cut.

Support for living costs will be in the form of non-repayable maintenance grants and repayable maintenance loans. Browne suggested that students should receive support for living costs through an annual flat rate entitlement maintenance loan of £3,750. As with the tuition fee, this would begin to be repaid when the student starts earning £21,000 or more. The Government has confirmed that maintenance loans will be part of the support package, but with the amount available to each student being dependent on their household income, whether they choose to live away from their family home or not, and whether they choose to study inside or outside of London. For example up to £7,675 a year will be available to students living away from home and studying in London.

In addition to maintenance loans, the Government has proposed that students from families with incomes of up to £25,000 will be entitled to a maintenance grant of £3,250 and those from families with incomes up to about £42,000 will be entitled to a partial grant. It is worth noting that these terms are less generous than those suggested by Browne, whose family upper-income threshold for the receipt of grants was £60,000 compared to the Government's £42,000.

[1] http://www.privateschools.co.uk/school-guide/school-fees/

Therefore a student from a home with two parents, each bringing home a very modest income of £22,000 will not be entitled to any maintenance grant. With the minimum cost of student living (outside of London) estimated to be approximately £8,000[2], even with the maximum loan entitlement of £5,500 (for students living away from home and studying outside of London), the student will have to find an additional £2,500 a year (or £48 a week) to make ends meet. If his parents can't, or won't, offer financial support, then, assuming earning the current minimum wage of £4.92 per hour for 18 to 20 year olds, he should budget for working about 10 hours a week to avoid having to take out additional debt on more commercial terms.

A further consideration is whether the new proposals will make it more difficult for young people to start climbing the housing ladder. The Government has said that 'the Council for Mortgage Lenders advise that a student loan is very unlikely to affect your ability to get a mortgage'[3] and that 'mortgage lenders usually take account of your monthly net income. Under the new scheme, graduates will have a higher monthly income because the increase in the repayment threshold means that they will be making lower monthly repayments on their student loans'.[4]

Whilst this is true, it isn't the whole picture. Under the current system, whilst monthly repayments may be higher, a student can at least reasonably expect to have repaid his debt in full by his early thirties. This will leave him with a higher net income from that point onwards, therefore making a mortgage more affordable. In contrast, under the changed system, a student is paying a 9% effective tax for the majority of his or her working life (depending on earnings). This reduces his monthly net income, and therefore it also reduces the amount he can afford to pay on a mortgage each month, and so it may also reduce the size of a mortgage that lenders are willing to offer.

The case studies help to illustrate this point. Let's assume that Tom, the middle earning civil servant, has an elder brother, Harry, who is subject to the current student finance system. They both do three year degrees and both go on to be civil servants, earning the exact same amount over their working lives.

[2] For example, http://www.manchester.ac.uk/international/money/costoflivingintheuk/ and http://www.essex.ac.uk/studentfinance/cost_of_living.aspx

[3] http://www.bis.gov.uk/policies/higher-education/students/student-finance/myth-buster

[4] ibid

Harry

Under the current system, Harry takes out a tuition fee loan of about £3,375 a year and a maintenance loan of about £3,500 a year. The earnings threshold is constant at £15,000 and he repays 9% of his salary over this amount. Everything else (for example, interest rates on the loans and salary) is the same for Harry as it is for Tom. By the time they are 35:

- Harry has made average repayments of £190 per month and has repaid his loan in full.
- Tom has made average repayments of £130 per month (£60 per month less than Harry). However he has not repaid his loan by the time he is 35. In fact Tom does not repay his loan until he is 50. Over the whole repayment period Tom makes average repayments of £280 per month.

Therefore, although comparable monthly repayments will be less under the proposed system, one benefit of the previous regime was that the repayments would likely end at the age when many adults are buying their first property, or looking to start a family.

Potential students should also be aware of and consider the other deductions that will be applied to their future income. For example, under the current income tax and national insurance regime, and assuming employee pension contributions of 4%, graduates' earnings between £21,000 and £42,475 will have total deductions of 45p for each additional pound earned. For income over £42,475 then for every extra pound earned, the level of deductions increases to 55p in the pound.

So, a graduate who earns £42,475 will face deductions amounting to some 34% of his total gross pay for a considerable period of his working life. And whilst the 9% student loans deduction element of this exists under the current tuition fee regime (and for income above £15,000 per annum rather than £21,000) the difference is that it will take many more years to repay the loan under the new proposals.

The big questions that potential students should be considering therefore are, (a) is it still worth going to university; and (b) where, and what, should I study? Ten years ago, the Government reported that graduates' lifetime earnings would be £400,000 greater than those who ended their full-time education with A-levels[5]. If so, then the financial benefits to the student of going to university (even with the higher fee levels) would certainly outweigh the financial cost.

However, recent estimates have tended to been more conservative. The University of Wales Swansea, looking at the pre-Browne system of student finance, after taking into account the costs of acquiring a degree (foregone earnings and tuition costs), reported that male graduates can expect to see their lifetime earnings (net of taxes) increased by £141,539 over similar men who finished their education with two or more A-levels. The corresponding figure for women was reported to be £157,982.[6]

Although this financial premium will reduce now the financial costs of tuition have increased, it is likely that there will still be a premium, particularly for students studying the most lucrative subjects at the best universities. In addition, there are other non-monetary benefits to having a degree. For example, graduates are likely to enjoy better health by being less likely to smoke, more likely to exercise, and less prone to depression[7].

Looking back, it is said that tuition fees have not, since their initial introduction at £1,000 per year in 1998, deterred students from going to university. However, unlike the current scheme, those initial £1,000 per year tuition fees were means tested, and whether payable upfront or not, £27,000 tuition for a three year course demands a lot more thought and consideration than £3,000 probably ever did. We acknowledge that universities need to secure additional investment to ensure

[5] www.prospects.ac.uk
[6] www.prospects.ac.uk
[7] www.prospects.ac.uk

their future success, and it seems equitable and defensible that those who benefit financially from higher education should make a fair contribution. We don't believe that the increased fees are likely to deter the majority of students. Those 17 year olds with parents who went through the university system, and are now successful professionals, have living proof of the financial, and other, benefits of higher education. They are more likely to have the confidence that they can succeed, the knowledge that a good university degree can help them succeed, and, perhaps most importantly, the expert careers advice from their knowledgeable parents and their parents' extended social networks. To them, a £40,000 debt which theoretically never has to be repaid, should feel like a sound investment choice.

But in our view it isn't the majority of students which the Government, and society as a whole, should be concerned about. It is those 17 year olds who are the first generation in their family to have the chance of going to university who need supporting. It is these 17 year olds who may lack the confidence in their own potential, who have less access to the all-important career know-how, and who may be unused to the concept of taking out debt to invest in the future. And these young people don't just need support in the form of bursaries and scholarships but through information, advice, guidance and through building their self-confidence from an early-age. Widening participation cannot therefore be something that is solely the responsibility of universities, but something that results from effective pre-school, school and other social interventions encountered throughout a child's life.

Assumptions

1. The Government has said that, a real rate of interest will be charged on loan repayments, but with a progressive taper:
   - For graduates earning below £21,000, there will be no real rate of interest applied to their loan
   - For graduates earning between £21,000 and around £41,000, a real rate of interest will start to be charged, reaching a maximum of inflation plus 3%

Above £41,000 the interest rate will be inflation plus 3%.We have assumed the taper applies as follows:

Interest rate	Salary bands
Inflation + 0.0%	£0 to £21,000
Inflation + 0.5%	£21,001 to £25,000
Inflation + 1.0%	£25,001 to £29,000
Inflation + 1.5%	£29,001 to £33,000
Inflation + 2.0%	£33,001 to £37,000
Inflation + 2.5%	£37,001 to £41,000
Inflation + 3.0%	£41,001 and above

2. Inflation is assumed to be 2.5%
3. The Government has said that the £21,000 earnings threshold will also be updated annually in line with earnings from April 2016. The earnings threshold of £21,000 is assumed to be updated annually by 2.5%

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For more information on the contents of this report, please contact our regional education specialists.

*source Higher Education Financial Yearbook 2011/12

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