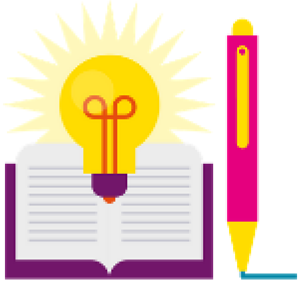
Perspectives

Legal updates for the world of higher education



September 2019

Dear Colleague

Leaving aside the continuing turmoil at Westminster, academic year 2019/20 begins in what is an extremely difficult climate for UK higher education institutions. The UK is facing a current demographic dip in the number of young people and there is concern about the impact of Brexit (currently scheduled for 31 October 2019) on demand for courses at UK institutions from EU students. In the absence of a cap on recruitment, competition between institutions for student numbers has been intense.

Over the summer it was announced in the national press that an 'alternative' higher education provider – GSM London - had gone into administration and ceased teaching students, with all the uncertainties and personal difficulties arising from that event.

The new regulatory regime brought in by the Higher Education and Research Act 2017 anticipated the need for institutions on the OfS Register of English Higher Education Providers to have a Student Protection Plan in place in the event of the closure of a course or an institution.

According to the press coverage, GSM London had not completed registration with the regulator, the Office for Students (OfS) and had not been included on the new Register of English Higher Education Providers. This meant, among other things, that its students would be unable going forward to obtain student finance for tuition fees and maintenance.

The OfS received its full suite of powers on 1 August 2019, having previously been operating under transitional provisions. The then Universities Minister Jo Johnson confirmed in a Government press statement that students *"can be confident that the OfS will be a champion for students which is able to take strong action. Our universities are world-leading and this reputation must be protected."*

In this edition of Perspectives, we look in more detail at the OfS requirements concerning Student Protection Plans and aspects of financial resilience, amongst other matters.

Specific legal, accountancy or insolvency advice should be taken by governing bodies to help guide them through the financial, regulatory and legal risks arising from these turbulent times.

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In this issue

Financial Resilience

One of the initial and ongoing conditions of registration of a higher education provider (a Provider) is that it must be both (i) financially viable and (ii) financially sustainable.

'Financially viable' means that the Provider is not at material risk of insolvency within 3 years.

'Financially sustainable' means that the Provider has sufficient financial resources to provide and fully deliver the HE courses that it has advertised and contracted to deliver, and to comply with all conditions of registration for a period of 5 years.

Ultimately, it is the OfS that determines whether either or both of those tests have been met, based on :

- financial information provided as a matter of course (audited financial statements and financial forecasts);
- information provided by a Provider as a 'reportable event'; and
- other intelligence and information that it might obtain from other sources.

The OfS, in their annual report on Financial Sustainability of Higher Education Providers published earlier this year, concluded that while the sector remained in "reasonable financial health", universities were going to be operating in a "complex, challenging and uncertain environment for some time".

In this environment, it is increasingly challenging for a Provider to make a judgment on its financial position looking forwards 3 or 5 years, and to demonstrate compliance with this ongoing condition. When preparing its financial forecasts, what assumptions does it make around the likely level of tuition fees going forwards post-Augar? Or the USS deficit position? Let alone the impact that Brexit may or may not have on the number of EU and non-EU students coming to study in the UK.

This is not just a question of compliance with regulatory conditions, however important they may be. Levels of borrowing in the sector are now at the highest they have ever been, and are predicted to rise still higher. A crucial part of financial resilience is therefore to ensure that not just OfS, but also third party funders, remain satisfied. They too have a significant interest in the ongoing financial health of the sector.

Given that the uncertain policy and political environment is unlikely to become any more certain in the near future, there are some practical steps that Providers can take in order to protect themselves.

1. **Know what is in the finance agreements**. Ensure that the Governing Body and key decision makers fully understand the terms of any existing lending arrangements. Finance agreements may have been entered into some time ago, and there may no longer be anyone in the finance department who was involved in their negotiation or is familiar with their terms. An audit of funding agreements will ensure that everyone is familiar with the restrictions that bind the university and provide comfort that the university is compliant. NB Don't assume that if there is more than one agreement with the same lender that they will be on identical terms. Precedent bank documents have altered significantly over time.

2. **Understand the financial covenants**. Financial covenants are the metrics that a lender uses to assess financial performance of a borrower. These may have been set - maybe many years ago - in a different financial environment. Certainly, there are many agreements still in place, which contain the old 'HEFCE' style covenants. So, it is quite possible to breach a financial covenant without being in an insolvent position, but maybe as a result of the impact of accounting standards changes or regulatory change. Make sure that the Governing Body and key decision makers understand what financial covenants

apply across all agreements, how these are calculated and what the definitions are, and continually monitor whether forecast events will (or may) cause these covenants to be breached.

3. **Don't ignore the lenders**. If updated forecasts are showing a potential issue with a financial covenant in the coming year, involve the lender early. It will be much easier for a lender to be flexible and supportive before a breach has actually occurred, when there is time to discuss why the issue has occurred, how it can be remedied and how the covenants may be amended or waived to protect both parties. Once a covenant has actually been breached, the lender will be on the back-foot and may have limited room to manoeuvre. And even if that lender is supportive, the existence of the breach may cross-default into other agreements.

4. **Auditors**. In order to sign off the financial statements on a going concern basis, the auditors will need to be satisfied that there are financial facilities available for at least the next 12 months. If there is a forecast breach of financial covenant, which would entitle a lender to accelerate the debt, this may mean that the auditors will not sign off the accounts unless there is a written waiver of that potential breach or an amendment of the covenant from the lender. This all takes time, so - as above - involve your lenders early.

5. **OfS**. The OfS has been clear that it is the obligation of Providers to notify them of any material changes in financial performance. The OfS has also indicated that they are more likely to intervene if they find out about a possible breach of a condition of registration through other sources than the affected university. If there is a forecast breach of financial covenant, or an issue with the going concern statement, consider whether this is a 'reportable event' and start a dialogue with the OfS.

6. **Minutes**. Ensure that all decisions at Governing Body, or Sub-Committee level, are fully minuted. It may be important to be able to demonstrate in the future that when a decision was made the decision-makers considered all necessary matters and fully understood the implications of what was being decided.

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Student protection plans

In this article we look at what student protection plans (SPPs) are, the indicators of non-compliance with ongoing regulatory requirements, and the gap between the regulatory view and the reality of student knowledge.

- It is an ongoing condition of registration with the Office for Students (OfS) that institutions have a student protection plan which:
- is easily available to current and prospective students;
- addresses the specific risks to the continuation of study for that provider's students in a proportionate way;
- provides more detailed plans where there is a higher risk of significant changes or closure; and
- includes minimum measures for ensuring that existing students can complete their course and continue to access student finance, or transfer to other providers.

This is very much in keeping with the principle applied by the Competition and Markets Authority in their guidance on consumer law, that to comply with consumer law institutions should provide prospective students with accurate, clear, unambiguous and timely material information before they make a decision about which courses and HE providers to apply to.

Any provider tempted to consider reviewing its student protection plan as a 'tick box' exercise once it has been registered should think again. The OfS has already required approximately a fifth of providers to improve their plans before it registered them, and has refused registration of one provider for reasons including that its SPP 'does not credibly assess the risks to continuation of study for the college's students' and that 'the actions set out in the draft plan to mitigate the risk to continuation of study, and the refund and compensation policy set out in the draft plan, are insufficient.

The current OfS framework provides non-exhaustive examples of behaviours that may indicate non-compliance with the general ongoing condition. These are that the provider:

- fails to publish its plan in a clear and accessible way;
- is not meeting the obligations set out in its plan;
- fails to submit an updated plan to the OfS as required;
- does not regularly review its plan and fails to update the plan to reflect changes in its circumstances;
- fails to engage with the OfS about the content of, and any updates to, its plan;
- has a plan that is not tested or fails to take into account the diversity of its students and their needs;
- fails to provide clear information about when and how the measures in its plan may be triggered.

In its recent report, higher education think tank HEPI reported that nearly all students (97%) want to know if their university is in financial difficulty. The SPP is the obvious means for a student to check an institution's identified risks to continuity of study (of which financial sustainability must be a risk, no matter how negligible in some instances), and the institution's plans should any particular risk materialise. However the HEPI report also finds that the overwhelming majority of students (89%) do not know what student protection plans are, while even more have not seen their own university's SPP (93%).

This indicates a clear gap between the importance of SPPs to the OfS, and the reality of student awareness. In theory then institutions should be doing more to publicise their SPPs in order to maintain their ongoing registration, and to help demonstrate their CMA compliance, but as the HEPI report also identifies, most students (84%) say they would have been less likely to have applied to their university if they had known it was in financial difficulty. Institutions in financial difficulties are therefore caught between an obligation to provide full risk information to applicants, and the reality that that same information is highly likely to impact negatively on recruitment, which in turn will exacerbate any financial difficulties.

The OfS has said that it intends to publish further guidance on student protection plans later this year, and institutions should ensure they take note.

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Northern Ireland's 2019: The Year of City Deals, No Deal and More?

Earlier this year, the UK Government approved the terms of an ambitious regional city deal for Belfast (BRCD), with both Queen's University and the University of Ulster named as key players in the £850m project. In July, a further City Deal was announced for the Derry and Strabane district area bringing with it over £100m of funding, including considerable investment in the University of Ulster.

Guest contributor Stuart Anderson from Carson McDowell gives us the detail...

With an increase in likelihood of a no deal Brexit, and a report on improving Higher Education in Northern Ireland set to be released, leaders in the sector are looking ahead to the autumn of 2019 with a great mix of uncertainty and anticipation. The stage has been set for the remainder of 2019 to bring with it a series of events which could have a radical impact on the sector in the region for years to come.

In terms of opportunities, the BRCD is posed to deliver unprecedented levels of regional investment in higher education as a driver of innovation. The UK Government, the Northern Ireland Civil Service and Belfast Regional City Deal Partners signed heads of terms at the end of March 2019. Subject to full business case approval of projects, the UK Government will commit up to £350m over a 15 year period from 2019/20, to be matched by the Northern Ireland devolved government, with a further £150m coming from the BRCD partners.

The BRCD partners are made up 6 local councils and the two Universities. Five key "pillars" are identified under the deal to drive growth including Infrastructure, Tourism and Regeneration, Employability and Skills, Digital and Innovation.

The Innovation Pillar will be led by the two Universities which will involve developing global centres of innovation excellence in priority growth sectors – Financial, Business & Professional Services, Agri-Food, Digital and Creative Technologies, Advanced Manufacturing, Life and Health Sciences, Tourism and Construction and Materials Handling.

Following the signing of the Heads of Terms (Phase 1) the BRCD moves into Phase 2, Delivery Development, which requires the development of Outline Business Cases for all projects which, if approved, will ultimately secure the funding before moving into Phase 3, the Implementation and Financial Plan.

The BRCD is an ambitious long term plan for economic growth and stability in the Belfast region. It targets £1billion of investment and over 20,000 jobs. Nonetheless, questions undoubtedly arise as to what impact a "no deal" Brexit may have upon the success of the BRCD and the future of higher education more broadly. A recent Department of Economy report notes, a "no-deal EU Exit carries a risk of a notable reduction in foreign direct investment which could result in less exports by foreign-owned businesses, reduced employment and lower productivity. All of which is likely to be extremely detrimental to the NI economy." The report goes onto set out the considerable exposure in a number of BRCD priority growth sectors, most notably in agri-food.

Whilst the settlement scheme for EU migrants and the UK Government's commitment to underwrite approved European research funding provide some comfort, the risks of a no deal for the sector UK-wide in terms of access to research funding, collaboration, student and staff mobility, amongst other things, remain and have been well documented. Unsurprisingly these issues are particularly acute for Northern Irish universities. This is best illustrated at the Magee Campus of the University of Ulster in Derry-Londonderry positioned just 5 miles from the border, with around 20% of its staff living on the Irish side of the near invisible border, and 1,200 students coming from the Republic.

Surrounded on three sides by the border with the Irish Republic, a no deal Brexit is expected to have considerable implications for the city, and consequently for the Magee Campus. Against that background the announcement of the £100m Derry-Strabane City Deal has been greeted with enthusiasm by local business leaders and politicians. Notably, the deal includes the establishment of a university medical education and innovation hub, creating 200 new research posts and adding a further 2,000 students.

However, the provision of higher education in Derry-Londonderry and the structure of the sector in the region will be brought into focus through the Northern Ireland (Executive Formation) Act 2019. Under the Act, the UK Government agreed to publish a report in September on improving higher education in Northern Ireland and on the establishment of a university whose principal campus is in Derry/Londonderry. As a result, the Derry-Strabane City Deal, at least insofar as it relates to the University of Ulster, may evolve into a materially different proposition than that which was initially envisaged.

The Northern Ireland higher education sector is clearly moving into a unique period of changes and consequential challenges. Questions remain over the extent to which opportunities intended to be created for the sector through the proposed City Deals will be impacted by Brexit, particularly in absence of a deal.

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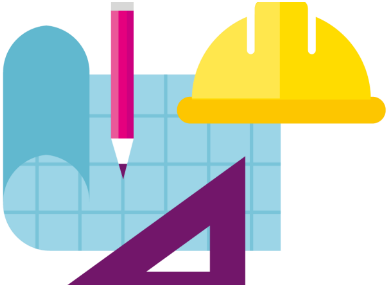
Options and issues facing universities wanting new or better purpose built student accommodation



The availability of quality purpose built student accommodation ("PBSA") is becoming an increasingly important factor for students when choosing their university. This, together with the fact that many universities have an under-supply of accommodation, means that many universities will be looking for ways to secure new or upgrade existing PBSA.

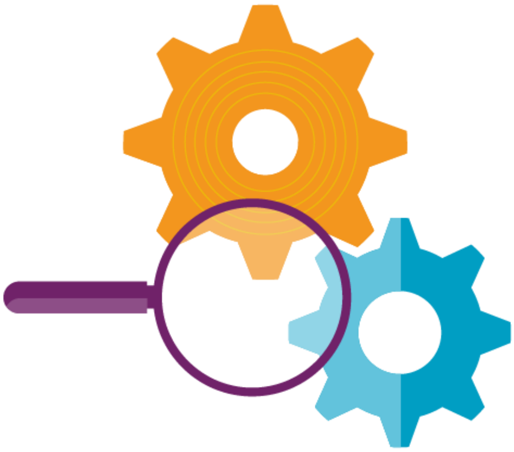
In the past 10 years, PBSA has become one of (if not "the") main alternative asset classes for private sector investors and funders. This means that universities looking to expand their PBSA stock have a range of available options - each with their own benefits and risks. The most suitable option (and whether it is available) will depend on a number of factors including:

- does the university have funds to deliver the project itself?
- does it have to be structured to be "off balance sheet"?
- does it require a capital receipt?
- does the university require the "best" financial deal for the long-term?
- what is the university's profile?
- does the university have access to land with development potential?
- is there proven student demand?
- is control over the PBSA important?
- are there any political sensitivity issues to consider?
- does the university want to transfer construction/ operational risk?

There is no "one-size-fits-all" so it is important that the university considers all factors and key-drivers before deciding on its preferred approach. In this article, we explore five of the main options and some of their key pros and cons.

Enter into nomination agreement with local providers

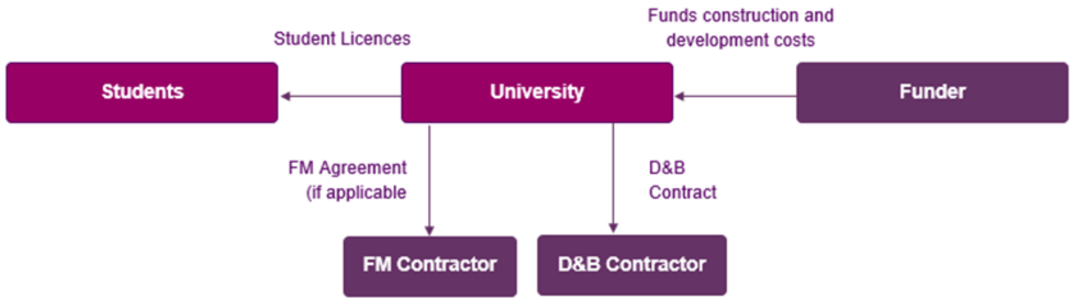
There are many specialist student accommodation operators delivering high quality PBSA. Entering into a "nominations agreement" with those operators provides a very simple and flexible way for universities to secure access to additional rooms. This option can provide the ideal solution for universities that do not regard student accommodation as "core business", or that need access to "spare" PBSA for its students. However, it does not give the university control over the PBSA - for example the level of rents charged to students, restrictions on non-student occupiers or assurance of quality. It also does not give the university the benefit of an income stream from the PBSA.



"Do it yourself"

Universities should always consider whether they are best placed to deliver the student accommodation, rather than entering into a deal with a private sector investor. Whilst this option typically requires a large upfront capital outlay, it is likely to be best option from a pure financial perspective over the long-term. It also allows the university the maximum flexibility and control over all aspects of the PBSA.

However, these benefits must be weighed against other factors such as borrowing restraints and other demands on the university budget. It is these factors which lead many universities to opt for one of the "outsourced" options explored below.

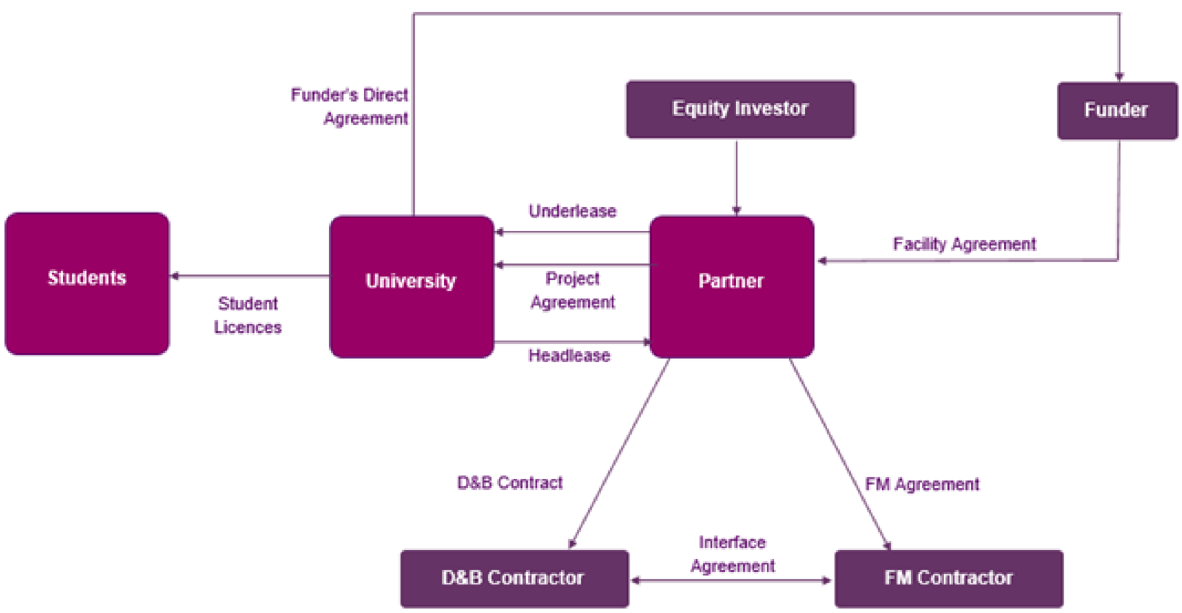


DBFO development partner who secures funding through a bond

Under this model the university engages a private sector partner ("PSP") to design, build (or refurbish), finance and operate ("DBFO") the PBSA and grants a long lease of the site to the PSP for which the university may receive a capital sum. The parties enter into a project agreement which governs their commercial relationship, determining, for example, the maximum rent the PSP can charge, the university's right to reserve rooms and its obligation to market them.

There are a number of advantages to this model, including that the university has no capital outlay, may receive a premium for the long lease and transfers "demand risk" to the PSP (as the university only pays for the rooms it reserves). This transfer of demand risk typically means that the project is "off balance sheet" for the university.

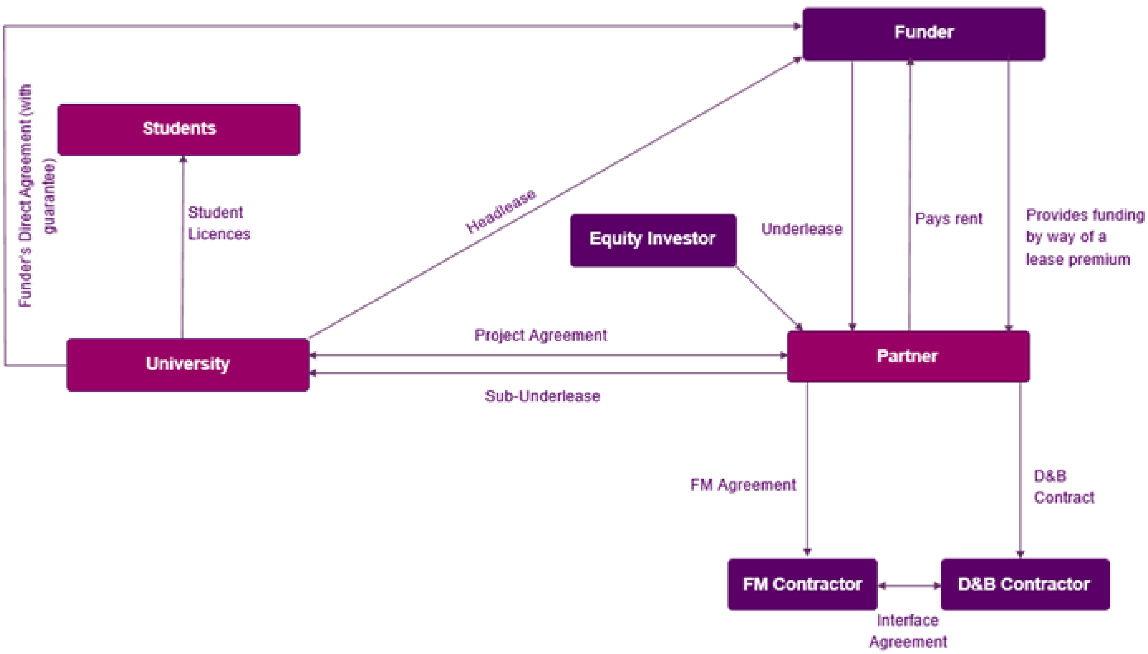
However, PSP's and their funders mitigate against taking demand risk by, for example, requiring the university to market the accommodation and restricting the university from entering into new PBSA deals until there is proven demand. The PSP and its funder may also seek additional protections. These vary in significance from project to project and may depend on the profile of the university and the overall student demand case.



DBFO development partner who secures funding through an income strip

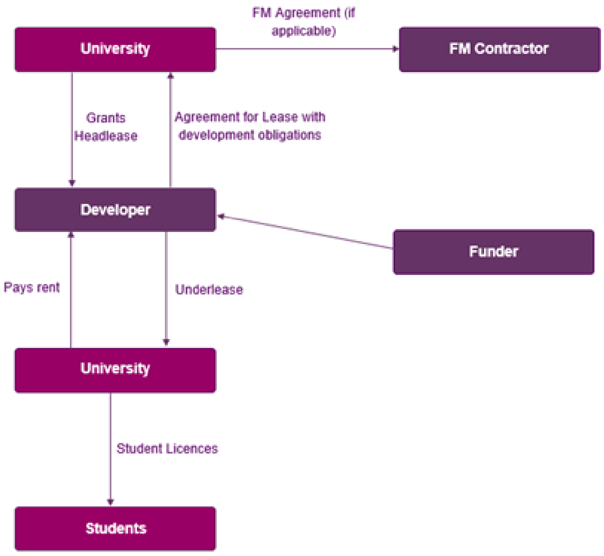
If bond finance is not available for a project, investors may opt for the “income strip” model. This is a relatively new (and for many universities, a very welcome) model for delivering PBSA. It gives universities access to a solution for delivering “off balance sheet” PBSA (auditors still view this solution as being off balance sheet if structured correctly) without the capital outlay and whilst still benefiting from an upfront premium.

Under this model, the university will have similar sets of rights, obligations and restrictions as under the bond financed DBFO model. However, there is one significant distinction: the university guarantees the SPV’s debt obligations to the funder. Universities can help to mitigate the risk of the guarantee being called upon by requiring the PSP to model sensible occupancy assumptions. For example, if the financial model relies on 100% occupancy for the SPV to be able to service the debt, this is significantly more risky than a model which requires only 80% occupancy.



Development partner using a lease and lease back structure

This is a more simple structure where the university appoints a development partner to fund, design and construct (but not operate) the PBSA. The university grants a headlease to the developer and the developer then grants a full repairing and insuring lease with rental obligations back to the university. Under this model, the university retains full control of the PBSA and receives a capital receipt for the lease. However, the rental obligation is “on balance sheet” and, over the long-term, it is likely to be a worse deal for the university financially compared to the “do it yourself” option.



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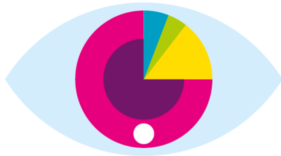

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