Research Fortnight

The Third Revolution

Part two of a major series investigating how new forms of capital and constitution are set to reshape higher education in England

'Demand would be enormous'

2. Bonds: the market

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Around the world, investors are fleeing from stocks and shares. Spooked by the prospects for western economies in the wake of the credit crunch, they are putting safety first. The objective for many is not, as it has been for the past half-century, capital accumulation. It is simply capital preservation.

This shift in sentiment has given any institution that can guarantee even a very low return on capital a strong hand. Despite losing its AAA credit rating, the US government, for example, can still borrow money at record low interest rates of around 2 per cent a year.

But it is not only nations that are in a strong position to borrow cheaply, so are large corporations—and universities. This form of borrowing is fixed for many years and done via bonds, a type of IOU. The lender receives an annual interest payment, or coupon, for a fixed number of years. At the end, the original sum is repaid.

For the borrower, the attraction is not just low interest rates but also the ability to lock down borrowing for as long as 50 years on fixed terms. With long-term bank lending still in short supply after the credit crunch, it can be difficult for universities to get loans lasting longer than 15 years.

In a nod to tradition, bonds issued by the US government are called Treasuries, and those issued by the UK government are called Gilts. Those issued by universities are just called bonds, and we may now be on the edge of a flood of them.

Last year, the economist David Blanchflower, a former member of the Bank of England's Monetary Policy Committee, wrote in favour of universities issuing bonds."In a recession, borrowing long term at low rates of interest is an eminently sensible thing to do—it is a classic Keynesian response," he argued. "The public sector can utilise the savings of the nation. This is a time to invest at low, long-run rates of interest. Bonds could allow universities to borrow money for important projects cheaply."[1]

Universities have taken note. Many are now taking a closer look at bonds according to the British Universities Finance Directors Group, BUFDG. The University of Cambridge is currently considering what would reportedly be the largest bond issue ever from an English university—for £300 million.[2]

But even that could be but a drop in the ocean. Banks say there is scope for universities to easily borrow another £4 billion whether through bonds or bank lending, much more even than the fabled cut in the Higher Education Funding Council for England's teaching grant. Chris Hearn, head of education at Barclays Corporate, says that from investors, "demand would be enormous."

If the current upheaval in higher education does prompt a new wave of borrowing, then the consequences for universities could be equally huge. For borrowing on this scale comes with strings attached. Experience in the US, where bonds are more common, shows that those strings are capable eventually of transforming not only the daily life of a university but its very purpose.

Public, private, and public-private

Bond issues at English universities go back to the 1990s and have been used mainly for big capital projects such as new buildings and debt restructuring. There are three main approaches – private, public and PFI.

In a private placement, the bonds are sold to a limited group of investors. York has £66m of bonds of this ilk maturing in 2047 at a coupon of 5.14 per cent and 5.16 per cent.[3] Manchester has £100m of similar borrowing maturing in 2046 with a coupon of 5.04 per cent.[4] Other universities said by banks to have made private placements in recent years include Imperial, Liverpool and Edinburgh.

The York case illustrates the costs involved. It paid £567,000 in fees, a little under 1 per cent of the amount borrowed.

In a public offering, the bonds are offered for sale in an open market and can be traded. For this, the institution will need to obtain a credit rating. The cost of this is in addition to professional fees and pushes the total cost up.

Standard & Poor's have provided Lancaster, Bristol, Nottingham, King's College London, Sheffield and others with investment grade credit ratings[5] while Moody's has a smaller piece of the market, providing ratings for Brunel and Keele.[6]

The experiences of Lancaster, the first university to make a public offering, illustrates both their mechanics and pitfalls. In 1995 the university obtained a credit rating from S&P and issued £35m at 9.75 per cent for 30 years.[7] But the covenants, or conditions, attached to the issue quickly became what Lancaster calls "onerous".

When you take out a mortgage, the lender is confident of getting its money back because it has an asset, your house, as security. But when tens or hundreds of millions are involved, lenders routinely ask for more. For public offerings, lenders have two extra lines of defence. First, the credit rating delves into the inner workings of the institution and scores it on a range of criteria, such as operating surplus and scope for cutting costs or increasing income. From time to time the rating is reviewed. If it drops below an agreed threshold, then lenders may be able to invoke their second line of defence, covenants in the contract governing the bond issue. Falling credit ratings and other specified "trigger events" allow bondholders to take steps against the issuer, often financial penalties to compensate the lender for increased risk.

In 1999, Lancaster "restructured" the bond. Ambac Insurance UK provided new insurance for bondholders, improving the credit rating to AAA. Lancaster says this removed some of the more onerous covenants, but also led to a small increase in the interest rate and created the need for Ambac consent for future projects. "Onerous ongoing property security obligations also remained in place," it says.

In 2009 Lancaster reorganised again, taking out a loan from the Royal Bank of Scotland and paying off the old bondholders early.[7] But there was a price to be paid. The bondholders received £14.5m in penalties and Ambac got £1.4m in termination fees. Escaping from high interest rates and an inflexible regime of covenants had cost Lancaster a cool £15.9m.

The only other public offering by a university, Greenwich's £30m issue in 1998, also ran into trouble and was withdrawn from the market in 2002.

In the 13 years since Greenwich, no university has made a public offering. And the credit crunch has now changed the market in two important ways. Specialist insurers like Ambac have either gone bust or fled the market, and banks say the minimum viable size for a public offering has risen to about £250m.

A third way that bonds occur within the HE sector is with Private Finance Initiatives. In a PFI scheme, a private company puts up the money for new infrastructure such as student accommodation; in return, the university pays annual fees, often for decades to come. The private company will often set up a dedicated firm, called a special purpose vehicle, to own the building. In turn, this may issue bonds to finance the development.

For example, in 2002 the University of Hertfordshire began a major project to build residences and sporting facilities. Ellenbrook Developments, whose holding company is a joint venture between RBS and the construction company Carillion, issued £60m of 30-year bonds to finance the project. As in the Lancaster case, a third party, Financial Security Assurance UK, insured the bonds. Fees paid by the university and student rents form the basis of the income Ellenbrook uses to repay its creditors, the bondholders.[8]

A similar, bigger example is the University of Sheffield's 2005 deal with Catalyst, a joint venture between the construction company Bovis Lend Lease and HSBC Infrastructure Fund involving bonds of £156.8m over 40 years.[9]

Robert McClatchey, managing director of Barclays Infrastructure Funds, has said there are now many more universities looking at these sorts of "accommodation partnership models". He has listed Durham, Bath, Bristol and Southampton as being among those considering private-sector partnerships for their residential estates.[10]

Motivation

At present, says Karel Thomas of the BUFDG, universities' interest in bonds centres on funding capital projects, typically new buildings. "Raising funds for investment in facilities through bond issues will work for some universities, most likely larger institutions with secure cash-flows and big investment plans, but will not be appropriate for all institutions," she says.

This is the kind of conventional reasoning that appears to lie behind Cambridge's interest. Andrew Reid, the university's director of finance, says it is looking at options "which may involve one or a mix of current cash resources, bank finance, private placement or public bonds". The university has been considering its options for some time and Reid now says, "we would expect to reach a conclusion within the next few months."

Newer motivations may emerge from the current turmoil in higher education. These could be as mundane as the desire of failing management to paper over the cracks in a flawed strategy. But more systemic drivers are plausible.

Some institutions may wish to avoid becoming trapped under what the University Alliance mission group has described as the £7,500 "cliff edge" defined by the level of tuition fees at which government quotas on student numbers start to bite. This could prompt them to start spending in a bid to justify higher fees to students.

Another example emerged in the report on the White Paper published by the Higher Education Policy Institute in August.[11] This warned of an "arms race" between English universities chasing students with grades of AAB or better at A-level. Fees from these students are not limited by quotas and they have therefore been described as "gold dust" by Steve Smith, vice-chancellor of Exeter and, until recently, president of Universities UK.

Hepi's analysis excluded the most elite universities and focused on the next tier of universities, those with significant numbers of AAB+ entrants and net fees of more than £7,500. This includes most of those already known to have issued bonds, including Manchester, Liverpool, York, Lancaster and Sheffield, as well as many others such as Leeds or Nottingham and places such as Kent which currently have as little as 10 per cent of entrants arriving with AAB+ grades. These are places in what the *Financial Times* has called the 'squeezed middle' or the bottom end of the 'new elite' and who may fear being shut out of an English Ivy League defined by success with AAB+ students.

Hepi argued, "These institutions will be vulnerable to losing some of their AAB+ students to more selective, more prestigious, institutions, and will at the same time be competing with their peers both to hold onto their existing and to recruit additional such students. This is likely to give rise to an arms race of 'merit-based' scholarships exclusively available for AAB+ students—if one university offers them others will be obliged to do so too or risk losing AAB+ students. The upshot may be that there will not in reality be a large movement in AAB+ students, but these universities will pay a high price to maintain their AAB+ numbers."

Kent has already validated the Hepi analysis to some extent by publicising £2,000 a year to students with AAA grades.[12] But Hepi went on, "Research into the impact of bursaries suggests that differences in inducements of £2000 or less have no measurable impact on student choice. To be effective universities would have to spend much more than this to 'buy' students."

Hepi's focus is on studentships, but other forms of spending are being considered by universities seeking to recruit AAB+ students. Russell Group universities say they expect smaller universities in the 1994 Group with high proportions of AAB+ students to seek to expand their intake. This could be aided by recruiting leading academics or building new facilities, for example, moves that universities say are also likely within the Russell Group.

Exeter is already seeking to leave the national pay bargaining scheme for academic staff.[13] In July, Sheffield announced a large investment in its engineering programme, commencing with £21m of new spending.[14] The university is reported to be recruiting an additional 21 academics, including six "world-leading" professors.

While these steps may have been under consideration for some time, similar moves could easily blur into the arms race identified by Hepi. The common factor among all such strategies is that they are likely to require substantial up-front investment. Which is where bonds could come in.

Turning to banks

Universities that want to borrow will, says Barclays, find plenty of willing lenders. Hearn believes the sector is 'under-leveraged' and could nearly double its borrowing.

"Universities currently borrow about £5bn, largely through bank finance," says Hearn. "But they probably have the capacity to generate close to an additional £4bn to £4.5bn."

"Time and time again we hear back from investors that they would desperately love to get their hands on anything to do with the university sector and it is surprising that no one has gone to that market yet."

Others are not so sure. Luke Reeve, a senior executive at Ernst & Young who has advised on recent issues, says just two pension funds bought all the recent private placements—and "they may be full of university paper already". Universities may need to find new buyers, or face a ceiling on the sector's long-term borrowing.

If buyers can be found, Hearn argues that virtually all the universities could achieve the *sine qua non* of a public offering, an investment grade credit rating. He expects them to be able to manage A to AA on the S&P scale, with some reaching AAA. But institutions further down the league tables face three distinct problems.

First, most of the post-1992 universities (though not Greenwich) are constituted as Higher Education Corporations and are legally incapable of issuing bonds—although the White Paper is consulting on allowing them to shed this legal form.

Second, smaller universities do not often need enough money to justify even a private placement, though Barclays says they could band together for a public issue.

Third, weaker institutions may lack the financial strength to obtain an investment grade credit rating. The Greenwich solution—insurance—is no longer available. But, says Hearn, this may be counterbalanced by the fact that UK universities now have a track record, are better understood and would be entering a sellers' market.

Even if they can get to market, Reeve warns that, "Smaller universities may find it more challenging as they do not have such fantastic real estate or diversified income revenues. They would have weaker ratings and would face a premium in cost pricing."

The squeeze on traditional long-term lending combined with the availability of bonds at low coupons for long periods means that there are likely to be more bond issues than in the past. Regulation will not hold univer-

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sities back—HEFCE does not monitor the use of financial instruments and it is hard to see them restricting established universities if they face new for-profit competitors.

The long-term nature of bonds is appealing to both issuers and buyers, but fixed payments can create risks for universities.

There are parallels in the NHS, where PFI has penetrated deeper. According to Nicholas Timmins, writing in the *Financial Times* in August: “no fewer than 22 hospitals spend so much of their income on fixed PFI payments—up to 18 per cent—that they no longer look financially viable”.[15]

Governance

More profound are the consequences of credit rating and the covenants on public offerings, where the conditions imposed can strike at the very heart of a university’s autonomy, as Lancaster discovered.

Problems are unlikely to arise in the short term at leading institutions. Reeve says the covenants on recent private placements were much less onerous than those with which Lancaster struggled, merely matching the commitments in the financial memoranda the universities had already agreed with HEFCE. For any university receiving HEFCE funds, the memoranda specify maximums for indicators such as cost-of-servicing-borrowing-to-income ratios, typically 4 per cent.

Nor is there in principle a great difference between private placements and conventional bank lending. Although the amounts would be smaller and the durations shorter, Reeve says, “Terms on the covenants for banking lending and bonds would be similar.”

So in the short term, while most universities remain ‘under-leveraged’ and in relatively rude financial health, the threat to their autonomy remains small. Lancaster was able to buy its way out of its problems, reflecting perhaps the stronger finances of universities after a decade of Labour largesse. It is in the longer term, in a more hostile environment, that the consequences for some universities could become transformative.

Imagine a university loaded with bonds on which it struggles to pay the coupons and no clear way of repaying the original capital. The bonds are secured on the general revenues of the university, there are covenants that it risks breaching and the credit ratings agency is breathing down its neck. What would happen then?

It is also worth asking how many universities—both governors and managers—are capable to handle the risk involved in big bond issues. Reeve says prudent financial management is becoming ever more important and wishes the issues were better understood. In 2000, a paper from the then Scottish Funding Council argued, “Unlike company boards, the governing bodies of Higher Education Institutions have on the whole not been designed for strategic management, but as bodies of representative of a wide constituency of interests.” Are England’s universities really any better prepared today?

A glimpse of possible future tensions in governance may be found on the Pacific coast, where the University of California has $13bn of bond debt and has pledged the tuition fees of generations of future students to maintain its AAA rating. Last Thursday, the governing council refused even to consider the budget plan proposed by the university president and it is no exaggeration to say the two sides are fighting over the soul of the university. Is its future as a public university—or a private one?

The second part of this article in the next issue of *Research Fortnight* will look at the potential long-term consequences of an increase in university bonds.

Next in The Third Revolution
Bonds: the consequences

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