Research Fortnight

The Third Revolution

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

Borrowing greatness

3. Bonds: Californian future

by Andrew McGettigan **am@ResearchResearch.com**
Series editor: William Cullerne Bown

WITH AN ANNUAL BUDGET of around $20 billion, the University of California is around half the size of the English higher-education sector. And in many ways UC has always looked like the more prestigious half of England's universities. Its campuses teach tens of thousands of high-achieving undergraduates and are home to some of the world's best researchers. The *2011 Academic Ranking of World Universities* from Shanghai Jiao Tong University lists seven of UC's ten campuses in the world's top 50; England has five.

Until relatively recently, the parallels extended to the funding of undergraduate teaching, which was mostly through a block grant from the State of California. In 1990, the state contributed $16,700 in today's money to the cost of educating each undergraduate at the university, some 80 per cent of the total. But in the early 1990s things began to change and during the past 20 years, the per-student subsidy provided by the state has dropped by $10,000, to just $6,700.

Meanwhile, tuition fees, often subsidised with federal loans, have risen rapidly. Chris Newfield, an academic at the university, told *Research Fortnight*, "Fees are raised every year—18 of the past 20—sometimes twice a year, and a third of the time by more than 10 per cent."

Tuition fees reached $12,192 this year, some £7,300. Income for undergraduate teaching from tuition fees now exceeds that from the state. In three years' time, controversial plans put forward by the university president last month could push them up by 80 per cent to $22,000. Converted into sterling, that is £14,000. And, like English universities pursuing overseas students, UC is subsidising domestic students with out-of-state student fees set at more than $35,000 (£21,000).

From Los Angeles or Berkeley, the replacement of the block grant in England by tuition fees looks very familiar. Our transformation is their transformation. It is just that in the UK we are doing in one year what has taken 20 years over there.

This supplement is the second half of a two-part article on bond financing in universities

Looking at our future

In California we can see some of the likely consequences of the reforms currently working their way through the English system. The system there bears comparison with what is in prospect for England, a kind of hybrid public-private model of higher education that was once heavily state-supported but which gradually becomes more private as politicians argue over how to tackle a lengthy budget crisis. It is especially interesting because California has been dealing with the tensions in the system. It shows how things that start off as questions of finance or politics can end up as questions of governance. Used to the comfort of large block grants, the governing councils and executives of English universities may be surprised by the depth of the issues, the long time-spans involved and the intensity of the ultimate crisis.

As at English universities, UC's governing council the 26-strong Board of Regents is required to approve financial plans put forward by management, led in California by the university president. But when the board met to consider the plan put forward by president Mark Yudof last month, tensions that had been hovering in the background for years exploded into the open. [1]

In an extraordinary and public meeting that the *San Francisco Chronicle* described as "a therapy session of sorts", Yudof's plan for a tuition fees rise of up to 80 per cent was kicked into the long grass. [2]

The problem is essentially that UC's leaders cannot agree on whether the university's future is as a public or private institution. Newfield, a former academic observer on the board, says, "UC's board can move neither forward towards sufficient private funding nor backwards toward restoring public funding to appropriate levels. One faction believes public funding is never coming back, and the other believes that private fundraising will never be able to replace public funds for operations. Many board members believe both at the same time."

Thus, on 15 September, the University of California entered a phase of existential crisis, unable to decide whether its future is as a public university with moderate tuition fees and squeezed finances, or a private one with high fees and comfortable finances. How did it come to this?

The university has had to contend with varying levels of political support over the past 20 years that have triggered big swings in its finances. But occassional years in which UC's funding seemed to improve can, with the benefit of hindsight, be seen as exceptions. For two decades per-student funding has been in decline as the state's budgetary problems have rumbled on and politicians have repeatedly chosen to reduce the block grant.

Taking the pledge

There was a significant change of gear at UC in 2003, when the university embraced general revenue bonds for the first time. [3]

In the US, bonds rather than bank loans are the normal method by which many universities arrange most of their borrowing. But until 2003, UC's bonds had been secured on specific projects or operations, such as medical facilities. The initiatives these capital development bonds financed were, from a bookkeeper's point of view, add-ons to a university core that was financed by the state.

General revenue bonds are different. These are bonds secured not against specific revenue streams, but against a pool of income. They have advantages for UC, allowing the university to borrow more, at lower interest rates. But they also depend heavily on the university's single most reliable source of income—tuition fees. Just how heavy this dependence is has only recently become clear.

Bob Meister, a professor at UC Santa Cruz who has served as an observer on the Regents, recently wrote an open letter to students entitled *They Pledged Your Tuition to Wall Street*. [4] "Since 2004," he wrote, "all of your tuition has been pledged in the sense that it will be paid into an account held by the bond trustee in the event of default."

In July this year, the California State Auditor reported that, "According to the university's director of operating budget, pledging tuition and fee revenue enables the university to obtain financing under more favourable terms. We found that the practice of pledging tuition and fees to secure bonds is also present in another public higher education system [the University of Texas]." [5]

In December 2010, UC had $7.6 billion of revenue pledged to an account in the hands of a bond trustee, Bank of New York Mellon. The auditors pointed out that, though pledged, no tuition fee income had been used for actual repayments. Instead, BNY Mellon routinely draws on other revenues first, to pay the bonds' coupons (interest payments), but could access tuition fees if needed.

By pledging its tuition fee income, UC was able to secure an AA credit rating, better than that enjoyed by the State of California. This reduced the coupon on bond issues by 0.2 per cent. With general revenue bonds now accounting for more than $6bn of loans that amounts to a saving of $12m a year.

But the importance of that AA rating goes beyond simply saving money. An example from Derby shows why it can be regarded as a strategic asset.

The competition for a UK government contract that the engineering firm Bombardier recently lost required it not only to build train carriages but also to secure financing to pay for 30 years of servicing. Siemens, the German firm that won the contract, held an A+ rating, Bombardier only BB+. Karel Williams, an academic at the University of Manchester has estimated this difference in rating would cost Bombardier £500 million over the life of the contract. [6] Academia may be a different world but the lesson is clear. A better credit rating can be the difference between winning and losing.

By 2007 UC seemed to have reached safe harbour. It agreed a multi-year budget with governor Arnold Schwarzenegger that would have avoided the need for any hikes in tuition fees. However, the state later reneged on the deal, a step UC has blamed on the state's own budget shortfalls, exacerbated by the global financial crisis.

The door to hugely bigger borrowings opened by general revenue bonds was one that UC finally went through in 2008-9, a watershed year that in retrospect can be seen as the start of the current crisis.

Reacting to the cuts in its block grant, the university declared 'an extreme financial emergency'. It made redundancies and temporary lay offs of teaching staff. It cut spending per student sharply, increased tuition fees. It also started borrowing billions more in general revenue bonds, aided by Barack Obama.

In an effort to stimulate economic activity, the Obama administration introduced the Build America Bonds scheme in 2009, providing bond issuers with a 35 per cent subsidy on the coupon. UC issued $3bn of bonds under the scheme before it closed.

Part of the cash went back to the State of California. It found itself so short of cash that it was unable to hand over to UC money it had agreed to provide for new research and medical facilities. To safeguard the facilities, UC loaned the state $200m, which the state then gave back to the university. If all goes well, UC will make a profit on the three-year deal as it is charging 3.2 per cent interest. [7] But a significant precedent had been set.

In the four years since 2007, UC's bond debt has almost doubled from $6.9bn to $12.8bn. Today its debt-to-income ratio is nearly 70 per cent, much higher than institutions of equivalent standing in the UK.

But for what is UC actually borrowing all this money?

The research connection

One area that is certainly losing money is research. The UC Advisory Group on Budget Strategies in 2010 said that in one year UC lost $720m in indirect support costs on research grants totalling $3.5bn. [8] Both Meister at Santa Cruz and Bob Samuels, an academic and union leader, say that—as at many UK universities—UC uses teaching income to subsidise research.

Meister's letter to students argues, "The bond documents don't say that new projects will generate surplus revenue that could be used to support instruction: they are not like private sector 'investments' that return a profit to the enterprise. Each new capital project that UC finances on its own, without state subsidy, is at best break-even.

"Most will be a permanent (perhaps growing) drain on campus resources that will be covered, first, by raising your tuition, second by spreading existing research support funds even thinner, and third by charging you more for other things, like student activities, while giving you less. The list goes on, but what you need to know is that even UC's new research labs and sports facilities can't be justified by how much new revenue they bring."

Samuels says the subsidy is, again as at many UK universities, obscured by accounting policies. At UC, he says, faculty research time that is not externally sponsored is often listed in accounts under "Instruction". [9]

Politics intervenes

The disputes at the top of UC illustrate the way in which apparently financial questions ultimately depend on interactions with state politics.

In the last two years, with its own finances shaky, the state has cut UC's funding by $1bn. In July, the state then asked UC for another loan—this time for $1bn, five times as much as before. [10] But that was not the only big financial/political play developing over the summer. Yudof was also pulling together something new for the Regents—a financial plan that the UC President ensured for the first time looked several years ahead.

The plan Yudof put forward on 15 September sought to address a projected budget shortfall of $2.5bn by 2015-16. Alongside efficiency savings, it proposed raising $1.5bn to cover tuition. And argued that if additional state funding for that were not forthcoming, then the burden would have to fall on undergraduates.

Yudof's plan proposed four years-worth of rises in tuition fees with the scale of increases linked directly to state funding. If the block grant was good, Yudof wanted to push fees up by 8 per cent; if not, by 16 per cent. In the worst-case scenario, fees would rise by 80 per cent, reaching around $22,000 by 2015-16.

The politics of this are familiar. Vice-chancellors on the board of Universities UK wrote a letter to the *Daily Telegraph* last December in the run up to the crunch vote on tuition fees that said in effect, if you cut our block grant then, yes, we must have higher tuition fees. [11]

But the Board of Regents did not see this as a canny gambit in a game of political chess with legislators. Despite having approved similar increases since 2006, some of the board viewed what was put in front of them as signalling a fundamental shift in the nature of the institution. For if the state failed to restore the block grant, UC would end up little different from a private university.

Chris Newfield's assessment of the factionalised debate on the board that ensued is enlightening.

> *There's a faction that opposes the multi-year budget on several co-mingled grounds. "This isn't the message we want to send" (Lansing), "this will scare people" (Lansing), this is "too negative," (Pattiz)—in other words, creating a clear relationship between falling public funding and rising student tuition is too scary or even punitive to seduce people into greater support. The other ground is hostility to further tuition increases as truly bad for students and bad public policy (Lansing, Newsome, Island). This group wants to appeal to the legislature or the public for a recommitment of public funds because of the university's value to the state.*

Another faction, led by Richard Blum, an investment banker who is married to Californian senator Dianne Feinstein, is in favour of leaving behind state support and moving towards a private future. Newfield says:

> *They are understandably sceptical that the legislature will be brought around by a better message campaign. It's true UC has been weak here ...but equally true that the legislature is unbelievably obtuse, to the point of running a perverse campaign against the future of its own population.*
>
> *David Crane offered a particularly eloquent summary of the legislature's preference for the salaries of prison guards over higher education. Gould rightly insisted on the importance of demonstrating to the legislature the actual consequences of its actions.*

Yudof's plan was rejected. But no other plan was adopted. The board members were simply not ready to endorse such a stark shift in the underlying purpose of their institution.

Will the existential crisis continue? Bonds can support prevarication by deferring capital repayments for

> ‘Even UC’s credit card is at least two-thirds of the way to maxing out.’

decades. A kind of debt dynamic can be initiated in which the capital repayments are repeatedly put off via the issuing of bonds, with the total level of borrowing climbing ever higher.

UC has over recent years issued several new flavours of bonds in order to increase its debt capacity beyond what was possible with traditional capital development bonds. General revenue bonds, now the ‘primary borrowing vehicle’, achieved this by pledging tuition fee income. More recent ‘project specific bonds’, accounting for $1.9bn of debt, achieved this by pledging gross revenues rather than net.

But, according to its most recent reports, even UC’s credit card is at least two-thirds of the way to maxing out. It only has the capacity to issue another $3-5bn in bonds to 2015 without affecting its credit rating.

Conclusions

To those from a corporate background, there is nothing unusual in all this. Heavy borrowing is routine for many big companies. For public universities, it is something new. And Samuels argues that the conditions imposed by credit ratings agencies penetrate the heart of UC.

“Not only do the bond raters help to determine the cost of borrowing, but they also tell universities what they should do in order to attaina clean bill of fiscal health,” he wrote. “For instance, Moody’s slipped into its bond rating for the UC system the need for the institution to restrain labour costs, increase tuition, diversify revenue streams, feed the money-making sectors, and resist the further unionisation of its employees.” [12]

It’s hard to argue against the numbers in California. Bond repayments are being financed by ever-higher tuition fees. The transformation enabled by bonds has pitted students against the institution’s own ambitions.

Barclays says most of the UK’s universities have strong finances and the sector has capacity to borrow another £4.5bn. [13] It might seem that the Californian scenario is a long way off. Surely, it would take decades of reckless capital splurging to reach UC’s public-or-private dilemma? Do university leaders really need to worry about all this stuff now?

There are five reasons why even the leading English universities that bear comparison with UC should pause.

First, the Californian experience shows that even as universities nurse students through sharp tuition fee increases, they prepare the ground among politicians for further fee rises and cuts in block grant. Bonds not only make life easier for universities, they also liberate a generation of politicians from their traditional responsibilities.

Second, Meister and Newfield say that UC’s AA rating depends on the university being able to raise tuition fees at will, an escape mechanism that is not open over here. (Though if universities over here borrow enough, and have big enough problems paying loans back, the pressure to lift the cap on fees may increase.)

Third, kicking the dilemmas down the road is one of the reasons UC is now at such a difficult crossroads. As Newfield says, for UC’s board, “The default strategy appears to be to avoid having an explicit strategy.”

Fourth, the University of California has long been a great university. But over the past 20 years it has come to rely on huge borrowings to finance continued brilliance. If it now uses up the last third of its available credit, it may find itself unable to sustain its greatness.

Fifth, in the US as in the UK the cuts in teaching block grant depend on increased individual debt with students taking out loans to pay ballooning fees—a process that must have a limit. Any collapse in demand could have severe consequences for higher education.

Next in The Third Revolution
The Student Loan Book

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