December 2004/**44**

Good practice

Guidance for managers

This report is for information and guidance

This document presents the results of a review of the pattern of borrowing in the higher education sector. It shows, for example, that the sector has increased its level of borrowing in proportion to income, and that borrowing costs have reduced overall. It also makes recommendations to help institutions better manage their borrowing.

Borrowing in the higher education sector

2004 update

© HEFCE 2004

HIGHER EDUCATION FUNDING COUNCIL FOR ENGLAND hefce

Borrowing in the higher education sector: 2004 update

To	Heads of HEFCE-funded higher education institutions Heads of universities in Northern Ireland
Of interest to	Senior managers, Finance directors, Finance committees
Reference	2004/**44**
Publication date	December 2004
Enquiries to	David James tel 0117 931 7328 e-mail d.james@hefce.ac.uk

Executive summary

Purpose

1. This document presents the results of a review of the pattern of borrowing in the higher education sector. It is an update of a similar survey in 2000, the results of which were published as HEFCE Circular Letter 23/00.

Key points

2. The review has found that since the last survey:

- the sector has increased its level of borrowing, and at a faster rate than its increase in income
- institutions are borrowing for longer periods
- there are differences in the degree of financial exposure
- borrowing costs have reduced overall
- the shift from fixed to variable rate borrowing increases financial risk
- some institutions may be able to reduce the cost of borrowing.

3. This document makes a number of recommendations to help institutions better manage their borrowing: it encourages institutions to define clearly their borrowing policies, determine appropriate loan instruments, and seek competitive quotes from lenders. It suggests that institutions should expect to borrow at no more than 1 per cent over base rate on variable loans, and aim for margins considerably better than this.

Action required

4. This report is for information and guidance. We recommend that it is brought to the attention of members of the finance committee, or its equivalent.

Introduction

5. In October 2000 we issued HEFCE Circular Letter 23/00, setting out the results of an analysis of the pattern of borrowing in the higher education (HE) sector up to 1998-99. The key message from that review was that there were considerable differences between institutions in the cost of borrowing, which could not be explained by the size of institution, size or type of loan, or other likely factors. This indicated there was scope for some HEIs to get better rates and thereby reduce costs, given the strength of covenant of the sector as a whole. We suggested that in most cases institutions should routinely expect margins no higher than 1 to 1.5 per cent over base rate on variable loans. Individual institutions representing a particularly low risk to lenders should be able to negotiate below those margins.

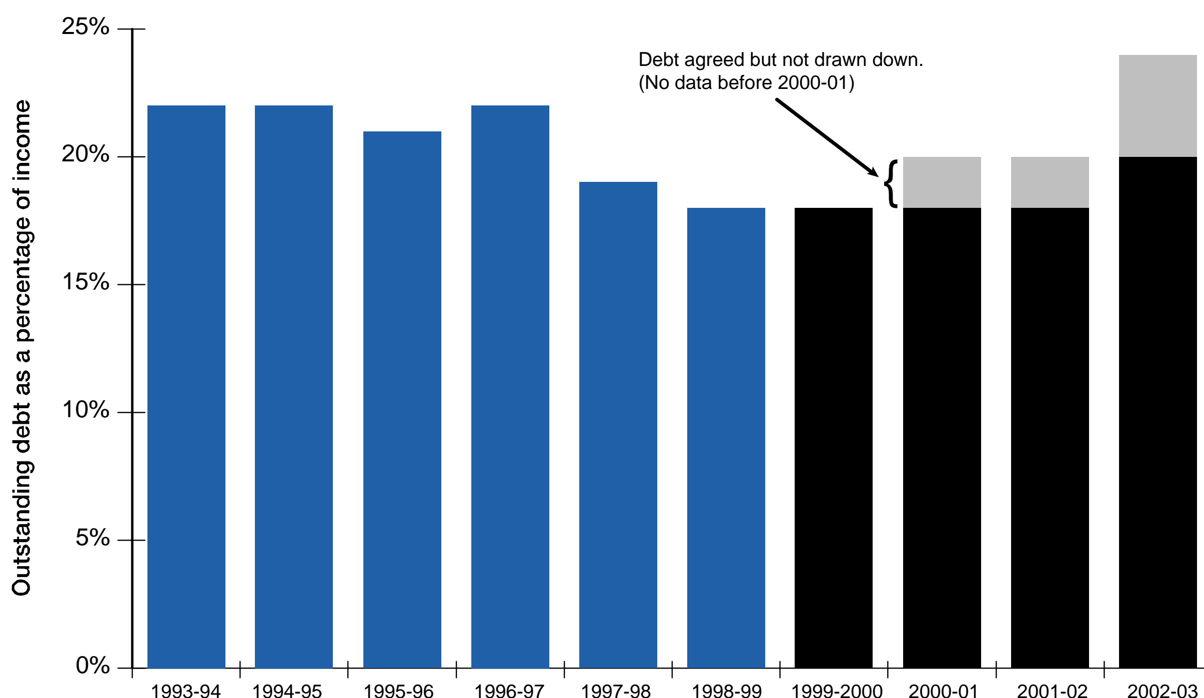
6. We have now updated our analysis of sector borrowing to 2002-03, drawing on information we collect from annual finance returns, as well as from requests for consent for borrowing under our Financial Memorandum with institutions. All data have been anonymised. We believe institutions will find it helpful to assess their borrowing arrangements against the sector's performance.

Findings of the review

The sector has increased its level of borrowing

7. Between 1998-99 and 2002-03 the sector increased its total borrowings by 57 per cent, from £1,584 million to £2,489 million. During this time the sector's income increased by 29 per cent, with the result that the total of debt outstanding as a percentage of income rose to nearly 20 per cent. This trend is even more noticeable when 'debt agreed but not drawn down' is included (see Figure 1).

Figure 1: Total debt outstanding as a percentage of income, all institutions, 1993-94 to 2002-03

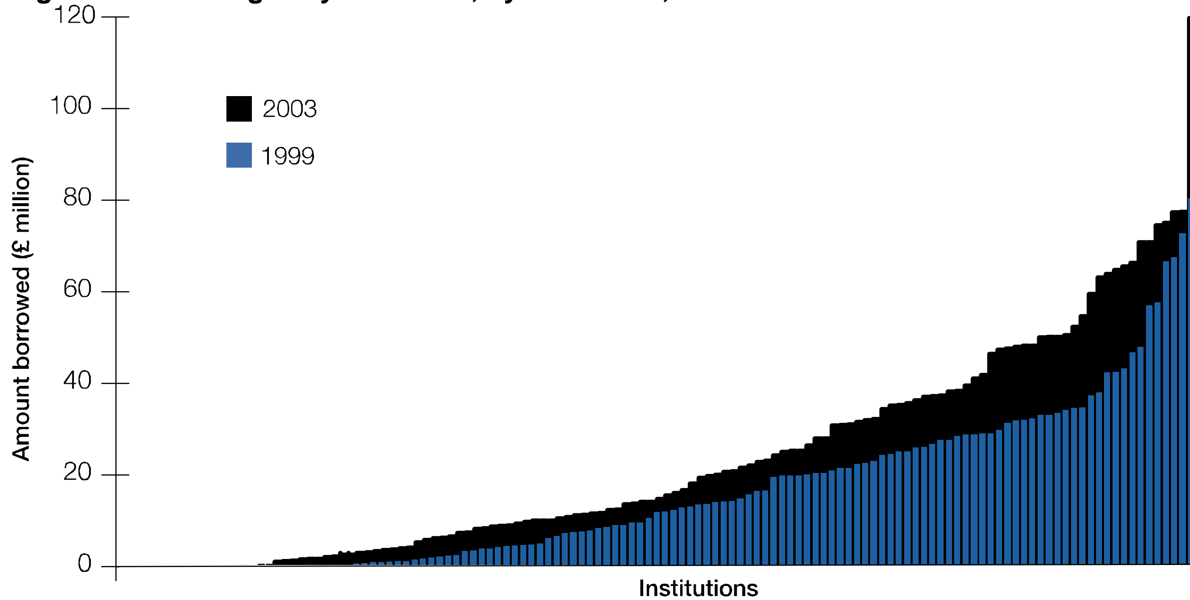


Note to Figure 1: A change in the method of data collection means it is not possible to identify separately before 2000-01 the amount of debt agreed but not drawn down. The four bars on the right indicate data not previously reported.

8. One explanation for this higher proportion of borrowing might be the significant increase in capital expenditure, which rose from £1.0 billion in 1999-2000 to £1.8 billion in 2002-03. However, the amount of new borrowing taken out to finance this expenditure has remained fairly constant at around £300 million each year. This has been possible because institutions have received more money from capital grants and asset sales.

9. The increase in borrowing is widespread across the sector, rather than confined to only a few institutions. Figure 2 shows the amount originally borrowed (not the amount outstanding) by each institution in 2003, ranked in ascending order of the amount borrowed, compared with 1999. Each vertical bar represents one institution, and the blank space between the graph origin and the first entry represents those institutions that had no borrowing. The corresponding data for 1999 is shown as the blue columns in front of the black shading, though the sequence of institutions is not always the same in the two years of comparison. The largest amount originally borrowed in 2003 was £120 million, compared to £80 million in 1999 (these two loans were for different institutions).

Figure 2: Total originally borrowed, by institution, 2002-03 and 1999-2000

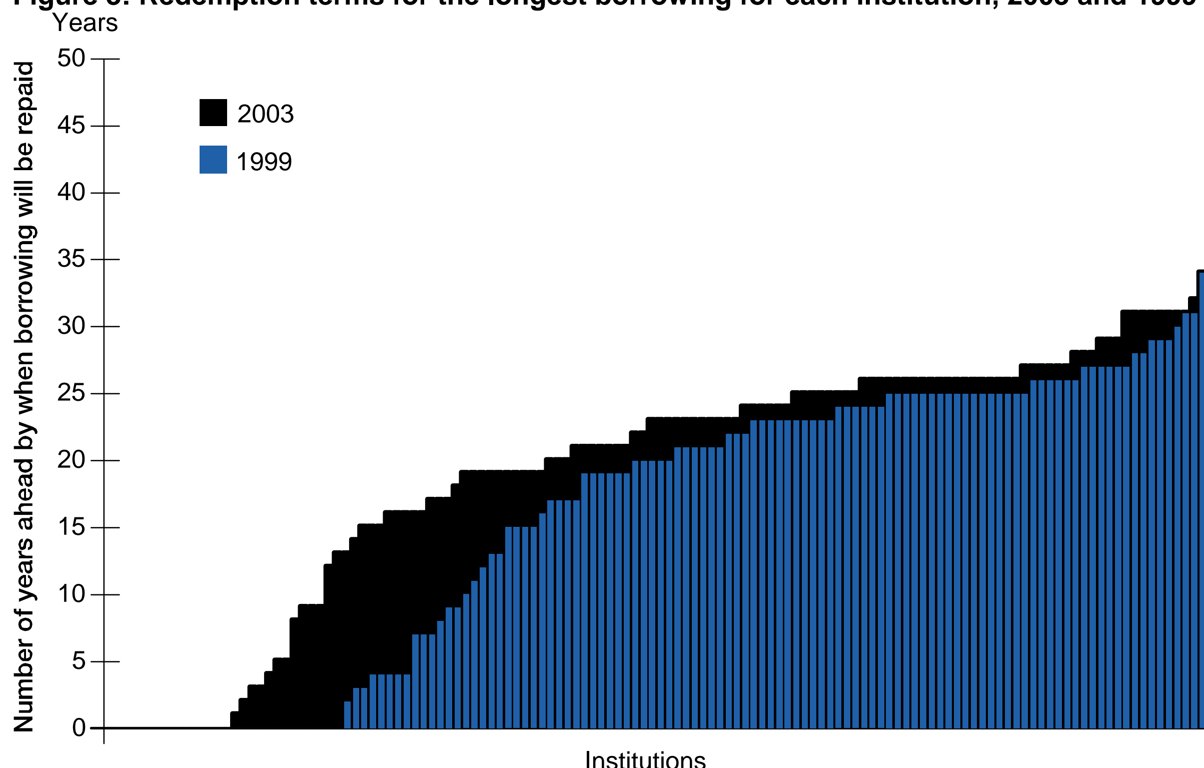


10. Figure 2 shows that more debt has been incurred by more institutions; the number of institutions without any debt has declined from 31 to 15.

Institutions are borrowing for longer periods

11. The length of time for which institutions will remain indebted has increased since 1999. In Figure 3 each vertical bar represents one institution (not one loan), and the height of the bar represents the number of years ahead by when all borrowings will have been repaid. The blank space between the graph origin and the first entry represents those institutions that have no borrowing. The borrowings shown are not necessarily for the same amount, nor do they give any indication of the total borrowing of any institution. The blue columns give the corresponding data for 1999.

Figure 3: Redemption terms for the longest borrowing for each institution, 2003 and 1999



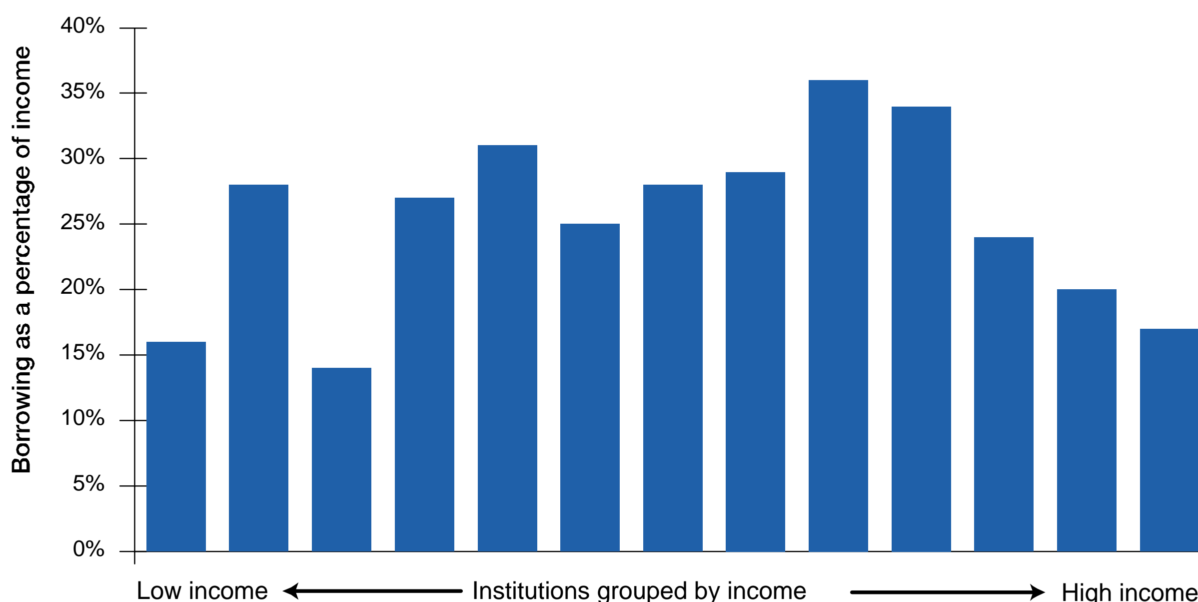
12. As at July 2003, on the basis of existing loans, more than half of institutions would still have borrowing outstanding in 20 years' time. Relatively few institutions borrow for periods shorter than 15 years. In other words, the increased level of borrowing indicated in Figure 1 has been spread over a longer period than previously. While this may be rational and prudent in the short term, it may slightly constrain some institutions' ability to borrow more money and manage additional costs in future years.

13. In spite of the increase in borrowing, interest payable as a proportion of income fell from 1.8 to 1.4 per cent between 1998-99 and 2002-03. Similarly, expressed as a proportion of operating surplus before interest charges, it fell from 50 to 45 per cent. This suggests that the current level of borrowing is sustainable for the sector as a whole, because of lower overall interest rates.

There are differences in the degree of financial exposure

14. Not all institutions have the same degree of financial exposure. As was the case in 1998-99, borrowing as a percentage of income varies considerably across the sector. Figure 4 ranks groups of institutions in order of size of income; each vertical bar represents an equal number of institutions, with those having the least income on the left and those having the highest income on the right. The height of each bar represents the mean average of original borrowing as a percentage of income. Mergers and changes in relative income make a direct comparison with 1998-99 difficult in this format. However, in 1998-99, only the central four bars were above 25 per cent, whereas in 2002-03 there were eight above that percentage.

Figure 4: Original borrowing as a percentage of current income, all institutions, 2002-03



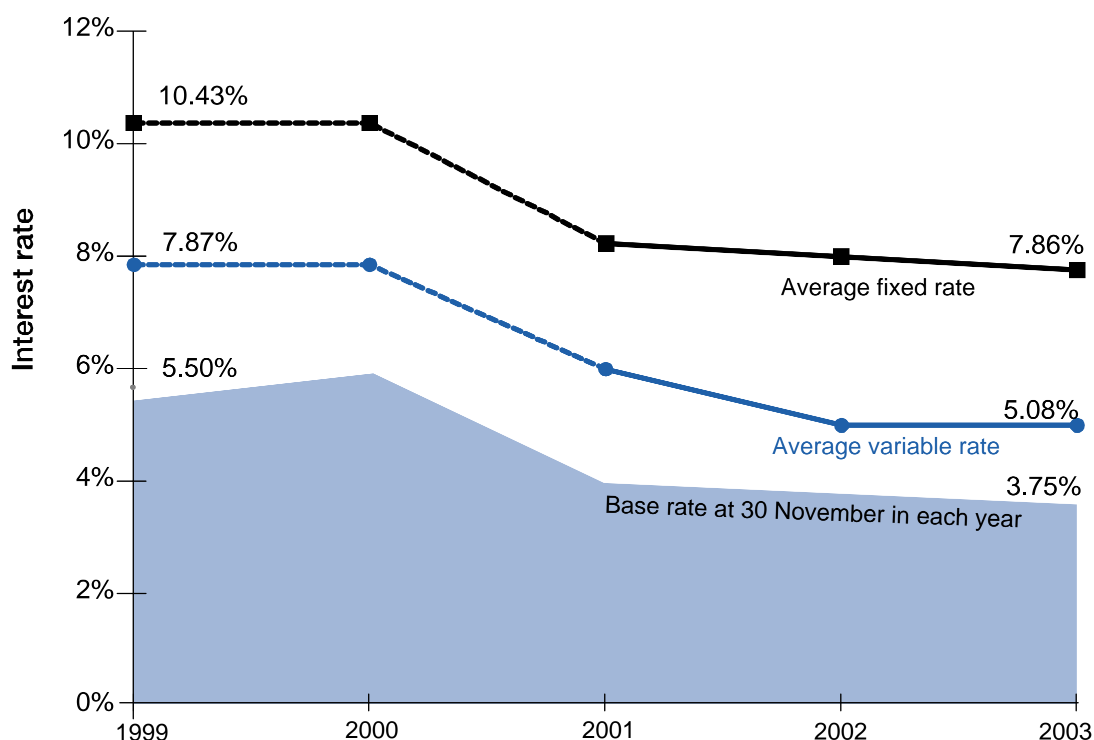
15. Figure 4 shows that, on average, both smaller and larger institutions have incurred less debt as a percentage of income than those in the middle range of income. Explanations for this may include differences in financial health, access to other sources of funding, need for capital expenditure, competition with similar institutions and attitudes to risk. Those mid-sized institutions with relatively high levels of borrowing may have less scope to borrow in future.

Borrowing costs have reduced

16. One of the key messages in the previous review (HEFCE Circular Letter 23/00) was that some institutions should be able to reduce the cost of borrowing. We encouraged them to consider different forms of borrowing, seek competitive quotes from lenders, and negotiate on the basis of the strength of covenant of the sector as a whole. All institutions should be able to benefit from the perception by lenders that the sector presents relatively low risk. Some institutions will always be able to obtain better rates than others, but our analysis showed that there was no reason why most, if not all, institutions should not routinely get margins of between 1 and 1.5 per cent over base rate. Financially strong institutions with high student demand and a good diversification of income should be able to obtain even narrower margins.

17. Since the previous review there has been an overall improvement in the cost of borrowing, as indicated in Figure 5.

Figure 5: Fixed and variable interest rates, all institutions, 1999 to 2003



Note to Figure 5: As a consequence of database changes, data for sector interest rates in 2000 are not compatible with the other four years. The 1999 figures have therefore been repeated.

18. Compared with 1999, the sector's average margin over base rate for variable and fixed rate borrowing has narrowed by around 1 per cent and 0.8 per cent respectively. This is a very significant gain, and may reflect institutions more actively seeking value for money, as we would have wished. It may also be the result of changes in the market, such as stronger competition between lenders and greater awareness and transparency of costs during a period of historically low and stable interest rates. It is worth noting that, while the margin between base rate and fixed rates has fallen, the gap between fixed and variable rates has not changed significantly. There is therefore a fairly constant 'premium' to be paid for certainty of future costs.

The shift to variable rate borrowing increases financial risk

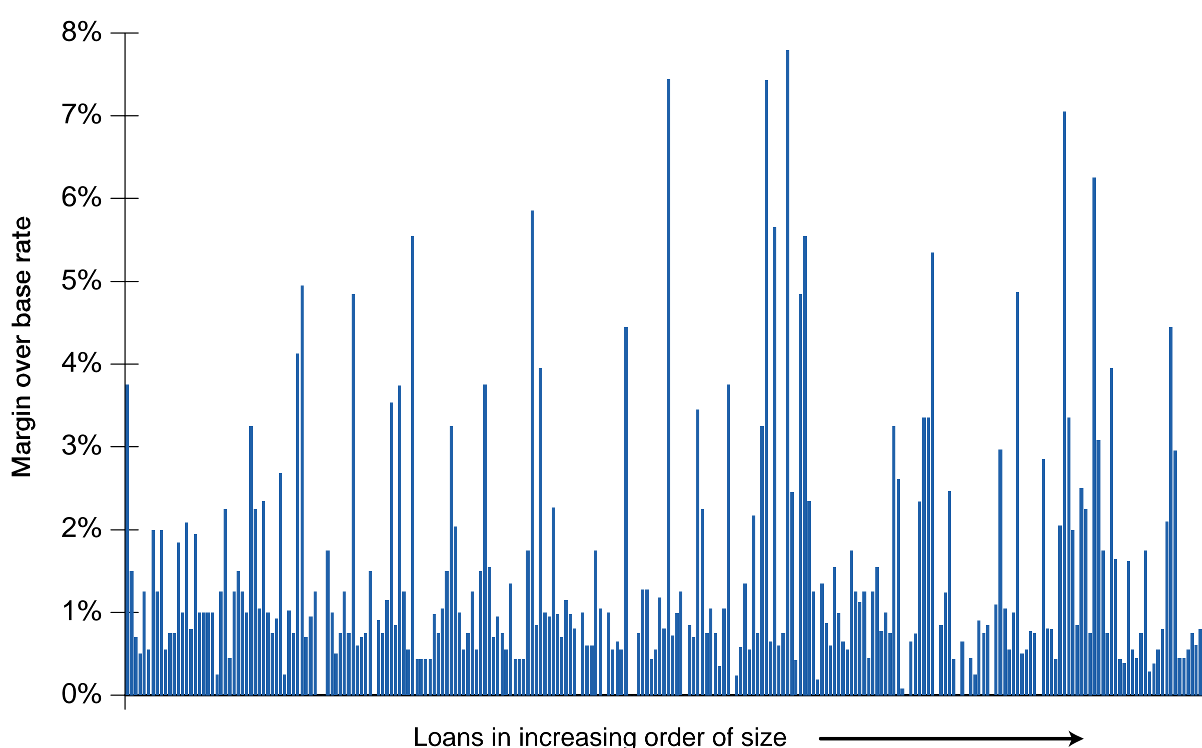
19. As average interest rates, and the margin over base rate, have both fallen, there has been a significant shift from fixed to variable rate borrowing. After a long period of little change, there was a marked increase in the proportion of borrowing that was at variable rates, from 40 per cent in 2002 to 47 per cent in 2003. As these figures include all debt, it is evident that a high proportion of either new or renegotiated loans were at a variable rate.

20. This shift may be a sensible response to low and relatively stable interest rates, given the higher cost of fixed rate borrowing. Institutions may take the view that base rates are unlikely to rise in the long run to the levels implied by fixed interest rates, and that therefore it is not worth paying the premium for certainty. Any sustained increase in rates might cause problems for some institutions.

Some institutions may be able to reduce the cost of borrowing

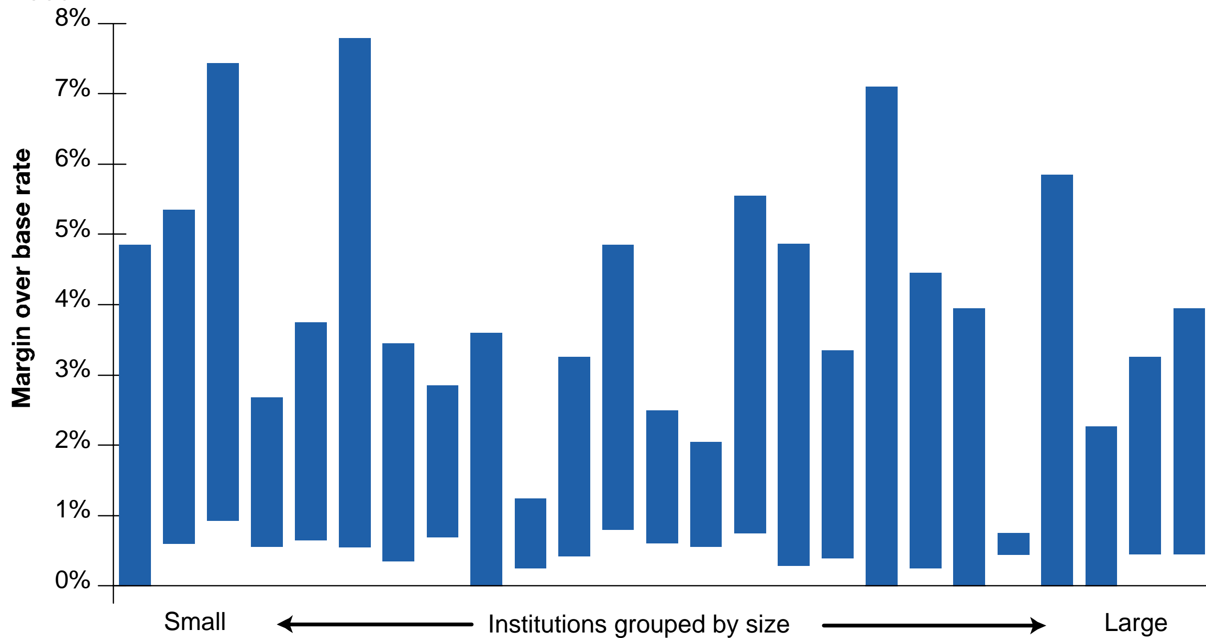
21. As in our previous survey, there are considerable differences in the cost of variable rate loans that do not relate to the size of loan. As mentioned above, the average margin over base rate has narrowed since 1999, but many loans in 2003 had a higher margin than the 1 to 1.5 per cent range we recommended. Figure 6 shows the margin paid over base rate for variable loans. The vertical bars represent individual loans, arranged in order of size, with the smallest on the left and the largest on the right. The highest variable rate paid was nearly 8 per cent over base rate. We have not investigated the circumstances of each loan, but it should be possible for some institutions to renegotiate better rates.

Figure 6: Variable borrowing margin over base rate by size of loan, 2003



22. Similarly, the cost of loans does not appear to be related to the size of an institution. Figure 7 shows a continuing wide disparity of rates for variable rate borrowing among institutions of a similar size. Each vertical bar represents a group of loans from several institutions of similar size. The bars are arranged in order of size of institution (determined by a combination of factors), with the smallest institutions on the left. The top and bottom of each bar is the largest and smallest margin over base rate paid for a loan in that group. For example, in the sixth group from the left, one institution paid nearly 8 per cent over base for a loan, while another institution of a similar size paid less than 1 per cent over base.

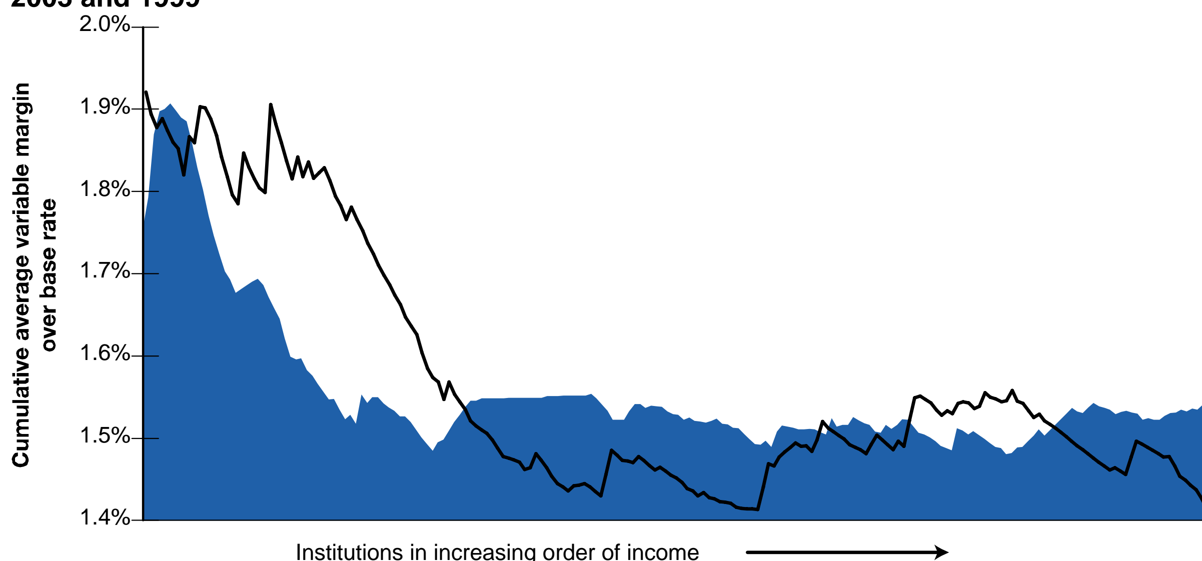
Figure 7: Range of margins above base rate, in ascending order of size of institution, 2003



Note to Figure 7: 'Size' is determined by a combination of factors.

23. Institutions of all sizes have been able to negotiate good rates, implying that most should be able to do so. However, it is generally the case that smaller institutions as a group are paying higher interest rates than larger ones. Figure 8 shows the cumulative average variable margin over base rate, by ascending order of income of institution. The solid line is for 2003, while the blue shaded area is the same data for 1999. As there were 36 fewer variable instruments in 1999, the representation of direct comparison is difficult, so the graph shows the middle range of the 2003 loans, omitting the first and last 18.

Figure 8: Cumulative average variable margins over base rate by income of institution, 2003 and 1999

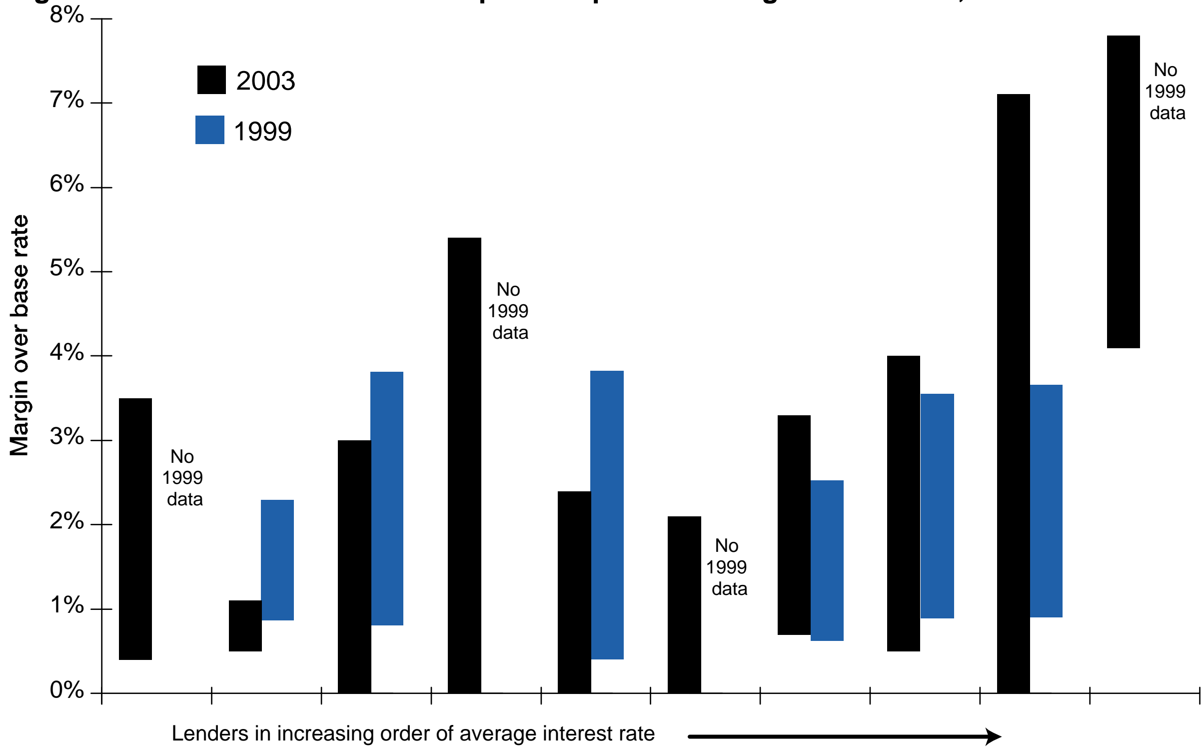


24. Figure 8 demonstrates that the average drops considerably when medium-sized and large institutions are included. The ranking of institutions by income has changed since 1999, as has the number of institutions and variable rate loans. Nonetheless, it is clear that smaller institutions routinely pay more for their loans than the rest of the sector.

25. Why are lenders offering less attractive terms to smaller institutions? There is little evidence that this part of the HE sector presents greater risk, or that lenders are less willing to provide loans. It may be the case that these institutions have less experience in negotiating loans and are less confident in the strength of their covenant. Such institutions can use our analysis to assist them in their negotiations.

26. The extent of differentiation by lenders is further illustrated by Figure 9, which shows the spread of margins over base rate by individual lender. Each vertical bar represents a group of loans, all of at least £1 million, granted by a single lender, with the lender offering the lowest average rate on the left. The top and bottom of each bar represents the largest and smallest margin over base rate charged by that lender. For example, the lender represented by the bar at the left had the lowest average rates and charged its lowest rate of 0.5 per cent over base and its highest rate of 3.5 per cent over base. The blue bars show comparable data for 1999, where reported.

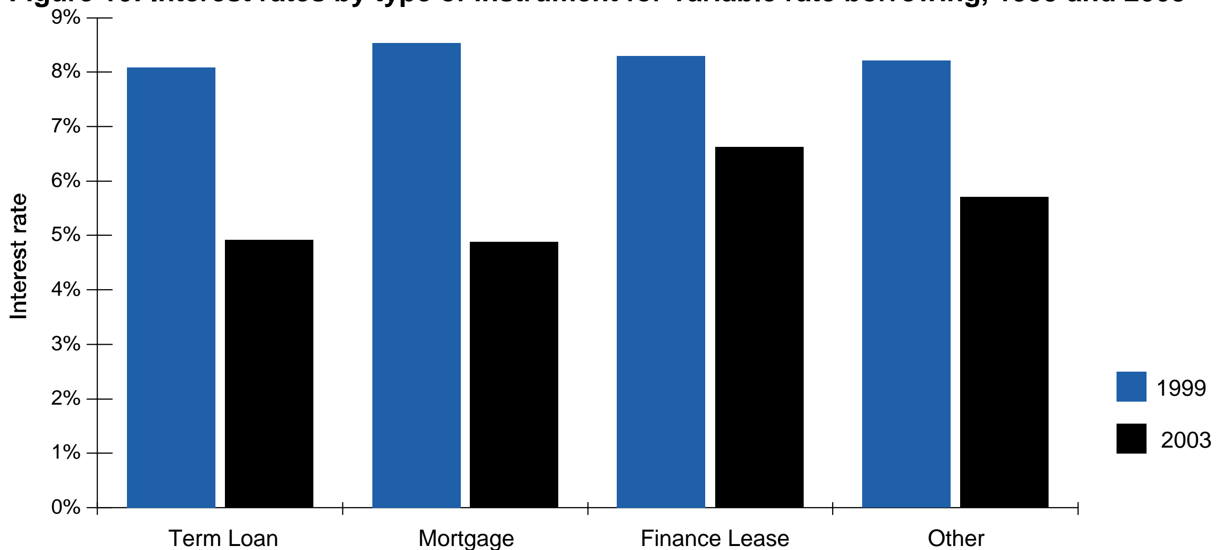
Figure 9: Individual lenders – Examples of spread of margins over base, 2003 and 1999



27. As in 1999, there are material differences between lenders, and each lender offers much better rates to some institutions than others.

28. At the time of the previous survey the cost of all types of borrowing was very similar. As shown in Figure 10, in 2003 term loans and mortgages were considerably cheaper for variable rate borrowing, even though the cost of all types of instrument had fallen in response to reductions in interest rates. The tax advantages of finance leases may not now outweigh other costs.

Figure 10: Interest rates by type of instrument for variable rate borrowing, 1999 and 2003



Conclusions and recommendations

29. Between 1998-99 and 2002-03, the sector increased its total borrowings by 57 per cent. This review suggests that the sector's increased borrowing has been affordable because of reduced borrowing costs: both lower base rates and narrower margins. The latter may, in part, be the result of institutions taking up our advice in 2000 to seek competitive quotes, based on best practice in the sector. The higher level of gearing, with a greater proportion of borrowing at variable rates, increases financial risk. This may become a problem if interest rates rise significantly and for a sustained period above the historically low levels of recent years.

30. With this in mind we recommend that institutions:

a. Consider the purposes for which borrowing is to be used and match long term borrowing to long term needs, such as capital projects.
b. Consider the appropriate repayment period for loans, bearing in mind the impact of interest and loan repayments on cashflow, future income flows from capital projects, and the constraint on future borrowing capacity.
c. Set a policy for the maximum level of borrowing. This should be based on an assessment of what the institution can afford and needs to borrow to develop and remain sustainable. It could be defined using a number of measures, such as: total borrowing or interest charges as a proportion of income; gearing; and interest cover.
d. Decide on the appropriate mix between fixed and variable rate borrowing, and keep this under review as interest rates move.
e. Model the impact of higher interest rates and budget accordingly.
f. Expect to borrow at no more than 1 per cent over base rate on variable loans, and aim for margins considerably better than this. We particularly encourage small institutions to improve their margins.
g. Seek competitive quotes from different lenders and consider different forms of borrowing.