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UK university funding model under pressure

Constrained income growth and rising costs weigh on finances of UK universities

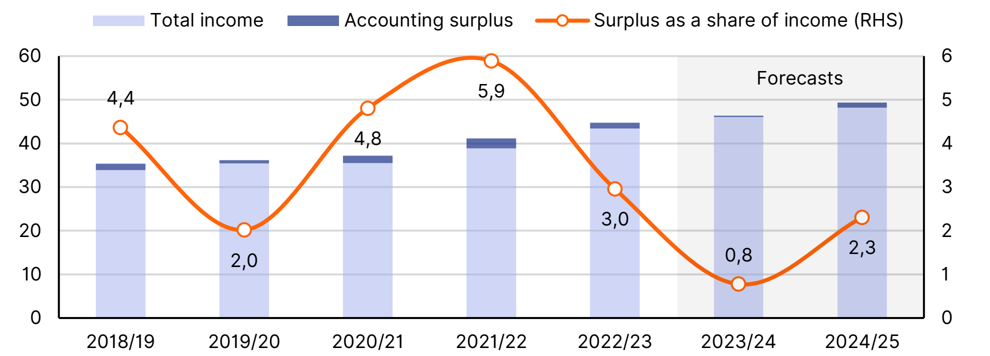
The UK higher education (HE) system enjoys a strong reputation globally, with a large number of highly-placed institutions in global rankings. Over the last decade, student numbers and revenue have expanded rapidly. However, the financial viability of some universities is uncertain because of increasing pressure on sector's funding model.

The challenges facing the funding model are manifold. A long-standing freeze on domestic undergraduate tuition fees has made many providers dependent on overseas students, a key vulnerability in an environment of heightened uncertainty around international student recruitment.

Challenges around income generation are compounded by heightened operating and financial cost pressures following the recent jump in inflation and the rise in interest rates. These headwinds are weighing on universities' financial performance and liquidity buffers at a time when they should be investing to maintain ageing estates and meet decarbonisation targets.

On the plus side, the creditworthiness of the UK HE sector remains solidly anchored by comparatively strong integration with the UK sovereign (AA/Stable), as reflected in a robust regulatory and legal framework and the contributions universities make to key UK government policy objectives. Sustained pressure on the credit quality of select individual educational providers warrants close monitoring and may also present an important challenge for the new UK government.

Figure 1: Accounting surplus of English universities
GBP bn (LHS), Share of total income, % (RHS)



Note: Surplus/(Deficit) defined as total income less total expenditure, excluding other gains or losses (from investments and fixed asset disposals), the share of surplus or deficit in joint ventures and associates, and changes to pension provisions.
Forecasts reflect figures submitted by HE providers to the Office for Students (OFS).
Source: OFS, Scope Ratings.

Future trends and opportunities

Adapting universities' business model

Many higher education institutions are implementing measures to strengthen their financial viability. These measures aim at generating efficiency gains, mainly through cost reductions and streamlining their course offerings. Despite these efforts, the magnitude of the current financial challenges means that more extensive and bolder cost-saving measures are needed.

Transforming cost structures and optimising income sources with higher margins to support tuition and research will become increasingly crucial for maintaining viability. Opportunities to reduce costs do exist, such as improving back-office efficiencies through shared-services or automation, but such changes are likely to require significant initial investments.

Consolidation across the sector is likely to gather pace

A House of Lords report of September 2023 noted that many industry participants indicated that they expected some consolidation in the sector[1]. There have already been examples of such moves in recent months. Earlier this year, City University and St George's University agreed to combine within the University of London federation, while Anglia Ruskin University and Writtle University College also announced they had agreed to merge. We expect this trend to continue, though other types of combinations such as jointly-run schools, shared academic staff over specific programmes or combined back-office functions are more likely to develop.

Policy outlook

New Labour government still to provide clear guidelines

The situation of the UK Higher Education system presents an important challenge for the new UK government. In its campaign manifesto, the Labour Party acknowledged the crisis the system faces and has committed to '*act to secure its future*', though it contains no commitments regarding tuition fees, funding grants or overseas students. While the party has stated that universities would play a central role within the government's industrial strategies, it has not yet put forward plans to significantly alter the sector's funding model.

Limited additional financial contributions likely, but potential for indirect government support

The main levers at the government's disposal include raising the cap on tuition fees and/or increasing direct funding to providers via higher teaching grant subsidies. Taking into account the priorities set out by Labour during the electoral campaign, the environment of tepid household purchasing power recovery, and the government's constrained fiscal position, we do not currently expect any significant reform to be rolled out concerning the UK HE sector.

The new government has communicated limited willingness to provide direct support, despite public calls to unlock funds to help universities undergoing financial stress. Still, possible changes in the government's stance in other key areas may support the sector's creditworthiness, including a softening of the UK student migration policy, which may help reverse the recent weakening in international demand and improve the revenue growth outlook.

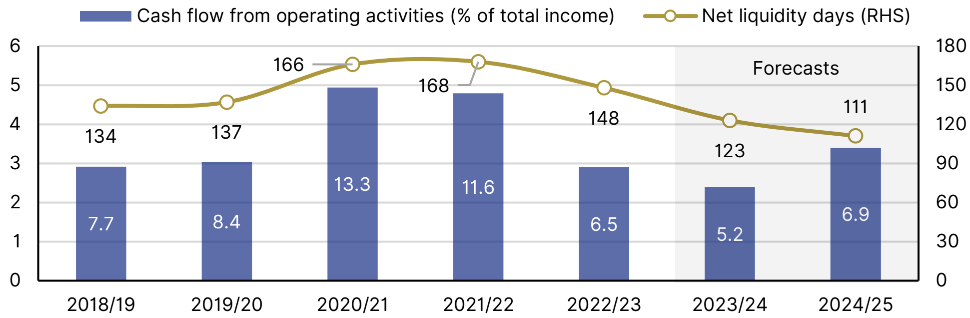
Overall financial health of the sector

The financial performance of UK universities deteriorated markedly last year. According to data published by the Higher Education Statistics Agency (HESA), the aggregate accounting surplus of the sector as a share of income halved in 2022/23 relative to the previous year (**Figure 1**), and 27% of providers were in deficit. Similarly, the Office for Students (OfS), England's HE regulator, recently reported that the aggregate cash flows of English universities as a share of total income nearly halved over the same period (**Figure 2**). The same report showed that English HE providers expected more deterioration in 2023/24, with 40% of providers expecting to be in deficit[2]. The

[1] House of Lords, Industry and Regulators Committee, September 2023 - Must do better: the Office for Students and the looming crisis facing higher education
[2] OFS, May 2024 - Financial sustainability of higher education providers in England

sector's liquidity position, as measured by the number of days average cash expenditures that are covered by cash holdings weakened as well, all although it remains broadly adequate.

Figure 2: English universities' financial performance has deteriorated
GBP bn (LHS), % (RHS)



Source: OfS, Scope Ratings

Aggregate forecasts project an improvement in the sector's financial performance from 2024/25 onwards, although this recovery is based on student body growth assumptions the OfS deems optimistic. The latest forecasts submitted by English HE providers show 35% growth in international student recruitment between 2022/23 and 2026/27, compared to a 24% increase in home student numbers. This clearly indicates a growing reliance on overseas tuition fees, which is in sharp contrast to near-term international demand indicators, adding concern to the sector's credit outlook. Data published by Enroly, a service used by international students to manage university enrolments, signalled a 36% drop in international student acceptances for the January 2024 intake relative to the previous year.[3]

Cost pressures amid stagnant domestic tuition fees

After the post-pandemic recovery in the two years to July 2022, the financial performance of the UK HE sector deteriorated markedly in the 2022/23 academic year. While the recent downturn can in large part be attributed to near-term external pressures such as inflation, these pressures have brought to the fore some key underlying vulnerabilities in the funding model of the UK HE system.

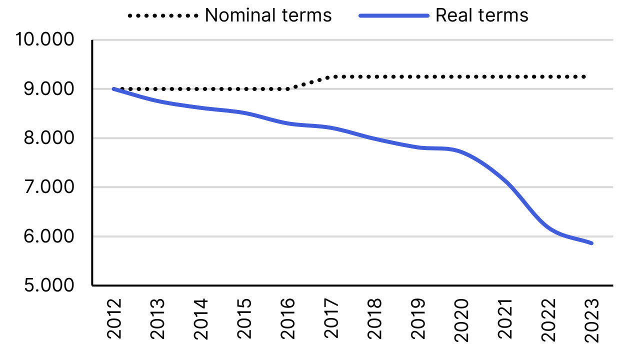
Home undergraduate tuition fees have fallen sharply in real terms

A key challenge to the HE system's funding model has been the gradual real-term decline in resources available for teaching domestic undergraduate students. The student finance reform of 2012 increased the level of UK undergraduate tuition fees from GBP 3,000 to GBP 9,000 per year. In 2017, the tuition fee cap was raised to GBP 9,250 and the initial intent was to link it to inflation thereafter. However, fees were frozen at GBP 9,250 in 2018, and have remained there since. This freeze has resulted in a sharp decrease in the inflation-adjusted value of tuition fees received by UK universities for teaching domestic undergraduate students. We estimate that domestic undergraduate student tuition fees declined by around a third in real terms between 2012 and 2023 (**Figure 3**).

Research from the Russell Group of high-profile universities estimated that English universities suffered an average loss of GBP 2,500 per UK undergraduate student in the 2022/23 academic year[4]. The same research suggests that this gap could grow to GBP 5,000 by the end of the decade under present trajectories as student fees and government grants do not rise in line with inflation. This projection does not take into account the expected increase in demand for support services and digital provision or educating more UK 18 year-olds in coming years.

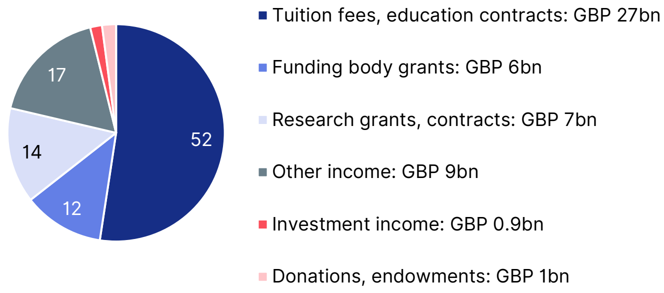
[3] Enroly, January 2024 - CAS and deposits rally but remain significantly down year-on-year as Pakistan leapfrogs Nigeria
[4] Russell Group, August 2023 - Briefing : University business model explainer

Figure 3: UK home student annual tuition fee cap
GBP



Note: Real term tuition fees are adjusted by the annual retail price index, excluding mortgage interest payments.
Source: U.K. Office for National Statistics (ONS), Scope Ratings

Figure 4: Aggregate UK HE providers income structure
% of total



Source: HESA, Scope ratings

Significant investment is needed to maintain and decarbonise university estates

In addition to operating cost pressures, UK HE providers face important capital expenditure needs. Many providers require significant investment in their estates to upgrade outdated buildings and meet net-zero targets. Around GBP 6.6bn of investment may be needed to decarbonise all HE built environments[5]. As many capital works were postponed during Covid to safeguard liquidity, providers must now compensate for this phase of under-investment in a context of elevated maintenance and financing costs and of narrowing operating margins.

Revenue side constraints and pressures

Teaching-intensive providers have been most impacted by the tuition fee cap

The cap on home undergraduate fees has been most impactful for teaching-intensive universities, as defined by the OfS as universities that generate more than 70% of their income from teaching-related activities. During the 2022/23 academic year, these providers derived nearly half of their total income from capped domestic tuition fees, against a quarter for the sector as a whole[6]. Teaching-intensive universities also tends to be characterised by weaker market profiles than more prestigious, research-intensive universities, which in turn translates into lower selectivity and greater exposure to fluctuations in student demand.

Demand from prospective UK students is decelerating in the context of the cost-of-living shock

While underlying domestic demographic trends are broadly supportive, with the number of 18 year-olds in England expected to grow steadily until the end of the decade, the recent cost-of-living shock raised the risk of dampening demand for higher education services from home students. In fact, lower-tariff universities suffered the most decline in UK undergraduate applicants relative to the previous year (-1.6% year-on-year change), against moderate but positive growth for higher tariff (0.3% YoY) and medium tariff (1.0% YoY) universities[7].

Aside from being less dependent on home undergraduate student fees, and therefore less exposed to the fee cap, high-profile, research-intensive universities are likely to benefit from the UK's re-entry on 1 January 2024 to Horizon, the European Union's flagship research programme. The programme has a budget of EUR 95.5bn and runs until 2027. In the previous period of the programme (2014-20), the UK was the second largest beneficiary, receiving EUR 7.8bn. The main beneficiaries are expected to be high-profile institutions like the University of Oxford (which received EUR 521m in funding in the programme's previous period) and the University of Cambridge (EUR 486m).

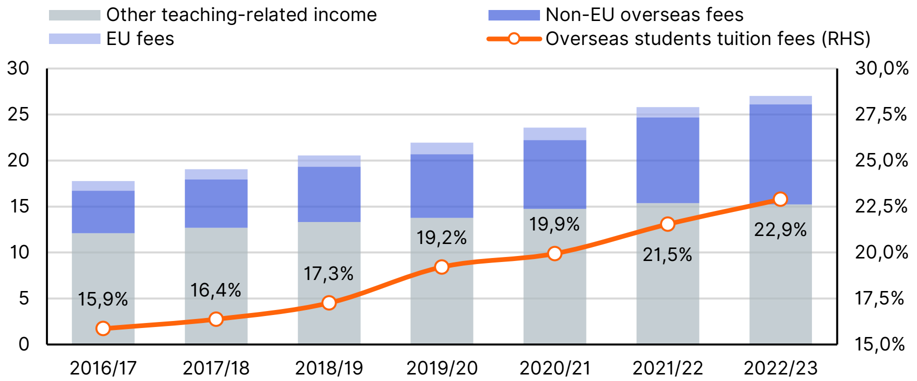
[5] EAUC, July 2023 – The cost of Net Zero
[6] The Institute for Fiscal Studies, June 2024 - Higher education finances: how have they fared, and what options will an incoming government have?
[7] The OFS classifies HE providers according to the UCAS tariff points held by undergraduates. For further details, please refer to the OFS' latest dedicated report.

Heightened reliance on international students raises revenue uncertainty

Reliance on overseas students has risen sharply

To compensate for the decline in real term revenue generated from teaching home undergraduate students, many HE providers have turned to increasing recruitment of overseas students, whose tuition fees are uncapped and typically pay more than double the amount paid by home students[8]. While this strategy has supported significant growth in past decades, associated vulnerabilities have become apparent in recent years. International fees account for over a quarter of universities' income, up from 15.9% in 2016/17 (**Figure 5**).

Figure 5: UK universities have grown increasingly reliant on overseas tuition fees
GBP bn (LHS), % of total income (RHS)



Source: HESA, Scope Ratings

There is significant variance between universities regarding dependence on foreign-student tuition fees (**Figure 6**). Elevated reliance on international students exposes universities' financial performance to changes in UK migration policy, high international competition and adverse external developments.

Demand from overseas students has weakened amid tighter migration policy

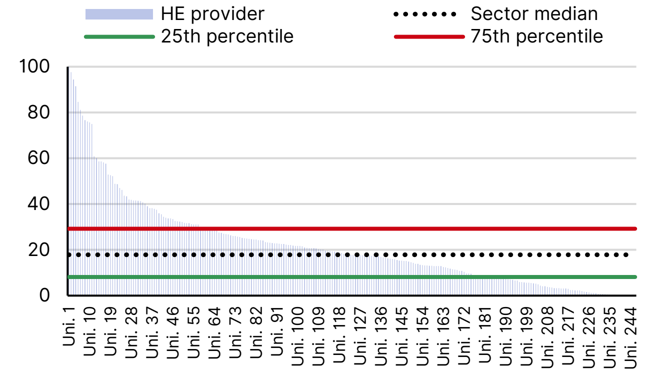
Recent changes to UK migration policy have significantly dampened international student demand. Since January 2024, international students studying in the UK are no longer able to bring dependants with them on their UK student visas, aside from those on postgraduate research programmes. In the 12 months to March 2024, sponsored study visas granted to main applicants fell 6% year-on-year while the number of visas issued to student dependents fell 25%[9]. The sharpest declines were for applicants coming from India and Nigeria, the two countries that contributed most to the rise in international applications in recent years (**Figure 7**).

Students from India, China and Nigeria constitute around a third of international students

Universities displaying low degrees of geographical diversification of student recruitment are most exposed to this trend. In 2020/21, half of UK universities recruited more than half of their post-graduate taught students from one country only[10]. High concentration makes universities vulnerable to adverse developments in key recruitment markets. For example, while student demand from Nigeria has been a major driver of overseas recruitment in recent years, UCAS data published in February showed a 46% drop in the number of Nigerian applicants to UK universities, most likely driven, at least in part, by the recent tightening of UK migration policy.

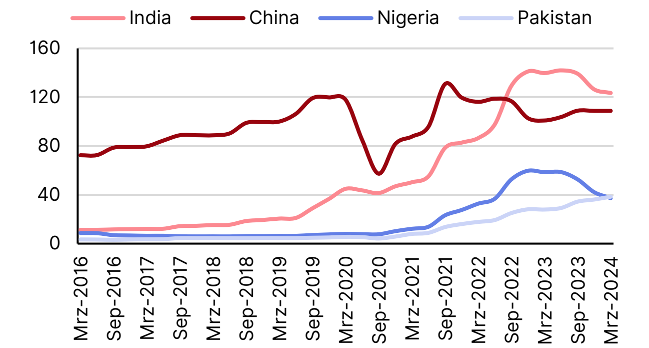
[8] British Council - Cost of studying and living in the UK
[9] UK Home Office - Immigration system statistics, year ending March 2024
[10] Universities UK - International student recruitment: geographical diversification of markets

Figure 6: Overseas tuition fees across UK HE providers
Share of total income



Source: HESA, Scope Ratings

Figure 7: Sponsored study visas granted
Total year-to-date, thousands



Source: U.K. Home Office, Scope Ratings

Concentrated recruitment markets raise income vulnerability

More than 150,000 Chinese students now study in the UK, roughly 22% of all international students. In May 2024, the OfS wrote to 23 universities with high numbers of Chinese students to flag risks associated with this over-reliance and to ensure they have contingency plans in case of a sudden decline in recruitment from the country. Moreover, concerns around dependence on Chinese student recruitment have risen in the present context of high global geopolitical tensions.

Low spending flexibility limits HE providers' ability to adjust

Operating costs have risen in line with inflation

The downturn in the sector's operating performance in 2022/23 was primarily driven by the sharp acceleration in inflation since 2021. The UK consumer price index rose by 10.5% in 2022 and 4.0% in 2023. For universities, this translated into soaring running costs, notably through higher utility bills, as well as salaries in line with higher staff wage demands.

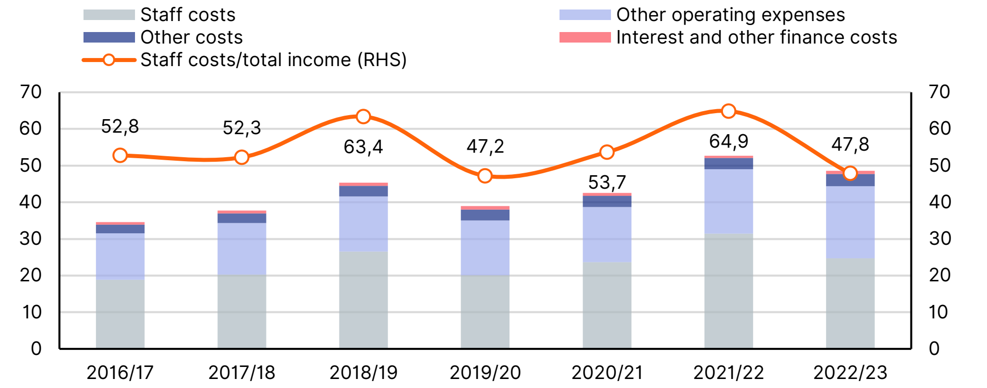
Most UK universities have limited leeway to address these pressures due to their comparatively low spending flexibility. The UK higher-education model is characterised by a low student-to-staff ratio compared to other university systems. Universities in the UK typically have a ratio of around 14:1, compared to an average of 18:1 in the EU and in the OECD.[11] While this high staff intensity constitutes a key driver of the favourable outcomes of the UK's higher education system and of its strong global standing, it also translates into a rigid expense structure for UK universities.

Personnel costs are usually the largest expense, representing around half of total revenue on average (**Figure 8**). Other rigidities stem from spending on student recruitment in a highly competitive national and international environment, and more broadly from difficulties in achieving cost savings without compromising student satisfaction.

Many providers have already taken measures to adapt to a less favourable operating environment, most notably via the roll out of severance schemes. Nearly 60 UK universities have announced redundancy schemes over the past year and English universities spent more than GBP 112m on severance payouts in 2023[12,13]. Such moves carry risks, however, as they may weigh on a university's quality of teaching and research, market position and ability to sustain future growth.

[11] King's College London, The Policy Institute - UK universities: from a Triangle of Sadness to a Brighter Future
[12] Queen Mary UCU – UK HE Shrinking
[13] Times Higher Education, January 2024 – University severance payouts top £100 million

Figure 8: UK universities' expenditure structure
GBP bn (LHS), % (RHS)



Source: HESA, Scope Ratings

High share of staff costs limits budgetary flexibility

Additionally, the rapid rise in funding costs over recent years has added to cost-side constraints, though the effects vary by provider. Those with low leverage levels and/or conservative debt structures, thanks to favourable refinancing profiles and/or largely fixed-rated liabilities, have largely been shielded from the shock. Conversely, providers whose debt is primarily variable- and/or whose debt is due to be refinanced over the medium-term will likely face a significant rise in their debt servicing costs.

Improved funding position of pension schemes will benefit providers

Positively, we note that the rise in interest rates has benefited the funding position of most UK universities' pension schemes, the largest of which – the Universities Superannuation Scheme – reported a GBP 7.4bn surplus following its 2023 valuation cycle, a sharp improvement from the GBP 14.1bn deficit reported in 2020. As a result, the university employer contribution rate was cut to 14.5% from 21.6%, while scheme members' benefits were revalued positively. This shift should partly alleviate wage-cost pressures for HE providers, favourably impacting the attractiveness of universities as employers in the context of a still-tight labour market.

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