Tertiary Education
Commission
Te Amorangi Mātauranga Matua

Risk assessment process for tertiary education institutions

and the Tertiary Education Commission's financial monitoring framework

Purpose

This document sets out how the Tertiary Education Commission (TEC) assesses risk for tertiary education institutions (TEIs). It is intended to provide transparency and clarity to TEIs and other stakeholders on key factors the TEC considers when assessing a TEI's overall risk level. This includes assessing key financial risk metrics through our financial monitoring framework (FMF). This document also sets out the TEC's high-level operational and financial performance expectations for TEIs.

Legislative settings

There are two primary sections within the Education and Training Act 2020 (the Act) that set the foundation of the TEC's monitoring of TEIs' operations and viability. These are:

- **Section 281(1)(e)** of the Act requires that a TEI Council must "ensure that the institution operates in a financially responsible manner that ensures efficient use of resources and maintains the institution's long-term viability".
- **Section 405(1)(a)** of the Act states that the Chief Executive of the TEC "must, on an ongoing basis, monitor institutions that receive funding in order to assess whether the operation or long-term viability of any of those institutions is at risk".

Each TEI is ultimately accountable for its own performance, operation and long-term viability. TEC's monitoring provides assurance to the Crown and New Zealand public that the public tertiary education network is sustainable. Where there are challenges, it enables early engagement and support, or, if necessary, informs the potential use of interventions by either the TEC Chief Executive or the responsible Minister.

Our performance expectations

To fulfil our monitoring role, the TEC takes a holistic view of an institution's performance, using both quantitative and qualitative information. We assess each TEI against a set of performance expectations and ultimately determine its overall risk level. An institution that operates in a sustainable manner and delivers high-quality outcomes is considered low risk. A high-risk institution has areas of performance that are below expectations and/or faces challenges that impact its long-term sustainability.

The performance expectations[1] below set out the key factors against which we "test" a TEI's performance when we are considering overall risk. Our operational and financial performance expectations come from many years of monitoring the financial viability and sustainability of tertiary education organisations, and identifying best practice across the sector. To develop these expectations we also identified elements of business practices that were "missing" when performance was poor, when we had to increase monitoring, or when more formal interventions were required. These performance expectations **do not** override specific guidance provided by the TEC on other matters, such as minimum educational performance expectations, priority areas of delivery, learner success, Gazette notices, Investment Plan guidance and funding conditions.

The TEC's primary expectation is that TEIs deliver high-quality education and research outcomes for learners, industry, communities and other stakeholders in a financially sustainable manner. To achieve this, a TEI needs:

1. **A strong and effective governance regime that sets the institution's long-term strategic direction, holds the Chief Executive/Vice-Chancellor to account, and ensures the institution operates in a financially responsible manner.** In general, the TEC expects the Council to:
    a. Understand the environment (including the full legal framework) within which it performs its functions and duties.
    b. Ensure meaningful and regular engagement with the stakeholders the institution serves.
    c. Develop and adopt a clear, achievable, and evidence-based institutional strategy that meets the needs of its stakeholders, addresses government educational priorities, and contributes positively to regional and national outcomes. The institutional strategy should be linked to a financial strategy and the TEI's forecast financial performance. We expect TEIs to clearly articulate their strategy and its benefits, and, when implemented, how it will deliver high quality and improved outcomes.

[1] While we have provided a comprehensive listing of expectations, this is not exhaustive, and there may be other expectations depending on the circumstances of each TEI. Where appropriate, we would communicate these directly to each TEI.

d. Satisfy itself that there is an adequately resourced, time-bound and robust work programme that will deliver the institutional strategy.

e. Hold the Chief Executive/Vice-Chancellor to account for the successful delivery of the work programme and have well documented key performance indicators, while maintaining a constructive, positive relationship.

f. Ensure management provides timely, good quality, well-presented information that supports and enables productive discussion and effective decision-making by Council members.

g. Develop and use an appropriate Council work plan that supports effective and timely decision-making.

h. Establish and maintain appropriate sub-committees with clearly defined roles that support Council decision-making. Independent representation should be considered, where appropriate, to strengthen sub-committee capability.

i. Actively monitor risk and risk management practices and ensure appropriate mitigations and responses are being put in place by management. This should include risk reporting being regularly provided to Council in a format that is usable and supports discussion. The Council should also be regularly reviewing financial modelling and scenario analysis to understand financial risk.

j. Undertake regular (at least once every two years) independent assessments of Council performance and operations and maintain up-to-date skills maps.

k. Work with the Chief Executive/Vice-Chancellor to ensure senior management have the appropriate resources (both capability and capacity) in place to implement the institutional strategy.

l. Actively monitor and understand the overall organisational health (including employee engagement, staff turnover, achievement of strategic goals etc).

m. Ensure compliance with all relevant legislation and regulations.

The TEC assesses this expectation through:

- engagement with key management staff and the Council chair
- analysis of a TEI's Investment Plan, its annual report, its statement of service performance or statement of performance expectations, and other institutional strategic documents
- analysis of financial reports submitted
- analysis of Council sub-committee and Council papers (where applicable)
- the results of governance self-reviews.

2. **A strong understanding of the drivers of financial performance and a clear, achievable financial strategy that ensures ongoing financial sustainability.** The Act requires that TEIs operate in a financially responsible manner that ensures the

efficient use of resources and maintains the institution's long-term viability**.** In general, the TEC expects:

a. Each TEI to deliver a financial result that allows it to implement its institutional strategy. This should include a robust assessment of the capital and cash flow required to fund an appropriate capital programme and allow for targeted investment in core operations and strategic initiatives.

b. Each TEI to accurately undertake robust budgeting and reforecasting exercises throughout the year, including scenario/sensitivity analysis. These activities should reflect what is achievable and realistic, rather than forecasting results that it "needs" or "would like" to achieve to deliver on its strategy and satisfy its stakeholders.

c. TEIs to be able to clearly articulate the assumptions behind financial forecasts and their associated confidence levels.

d. TEIs to regularly model plausible downside scenarios associated with key risks and put in place plans for how management will respond if these downside scenarios eventuate. These downside scenarios, the key risks and the available mitigations should be regularly reported to and considered by the Council.

e. TEIs to have a clear understanding of the drivers of financial performance and the profitability of their various business activities. This includes understanding the cost of serving learners and delivering research. We also expect TEIs to know the contribution margins generated at a course/faculty level and how cross-subsidisation of their central services and any non-profitable delivery (or campuses) occurs.

f. That if a TEI is not operating profitably (or in line with its financial/ institutional strategy), it should (in a timely manner) appropriately assess revenue growth opportunities, implement cost savings, or explore changes to its operating model that will put it on a path to profitability and long-term financial sustainability.

g. If long-term deficits are forecast, the TEI should prepare a financial recovery plan that is endorsed by its Council. Management should regularly report progress against this plan to Council. The plan should:

    i. Be informed by a minimum viability assessment to understand the level of change that is required.

    ii. Clearly identify the key challenges being experienced and their underlying cause.

    iii. Set out clear areas of focus to improve financial performance and the associated initiatives. Where appropriate, these should be linked back to the TEI's underlying challenges.

iv. Identify timelines, measures of success, and who is accountable for specific activities.

v. Include a summary of key risks and mitigations.

The TEC assesses this expectation through:

- engagement with senior management and finance personnel
- analysis of financial forecasts and other financial and enrolment information (including forecasting accuracy)
- the FMF
- benchmarking data
- audit management letters
- analysis of Council sub-committee and Council papers (where applicable)
- an assessment of the TEI's overall approach to risk management and its track record of dealing with disruptions and challenges.

3. **A strong understanding of learner enrolments and trends that helps support financial and operating decisions to ensure high-quality outcomes for learners.** In general, the TEC expects each TEI to:

    a. Have robust internal systems and operating processes in place to accurately monitor learner applications and enrolment conversion rates for both domestic and international learners.

    b. Have a clear understanding of changes in demographics and enrolment trends.

    c. Adapt to changing learner preferences. This may mean exploring alternative methods of teaching delivery or implementing changes to operating models.

    d. Design and implement evidence-based learner success initiatives to support increased student retention and completion rates. This should include understanding the return on investment.

    e. Regularly review its programme offering and staffing mix (academic and non-academic) to ensure it aligns with expected learner and industry demand. Any adjustments should be made in a timely manner and be considered against the overall financial performance/position of the TEI.

    f. Have a clear international student recruitment strategy. This should be interlinked with the finance strategy to support the TEI's financial performance as well as the institutional strategy to realise any international objectives while appropriately managing risk.

The TEC assesses this expectation through:

- engagement with TEIs
- analysis of Single Data Return submissions and other enrolment information
- educational performance indicators

- analysis of Investment Plans, Learner Success Plans, Disability Action Plans and learner recruitment strategies
- analysis of Council sub-committee and Council papers (where applicable).

4. **Policies and practices that ensure a TEI has appropriate cash reserves and liquidity to meet its financial commitments as they fall due.** In general, the TEC expects:

   a. TEIs to have strong forecasting and risk management capabilities, with internal policies and procedures being regularly reviewed and updated.

   b. TEIs to maintain an appropriate level of liquidity, so that they can meet their commitments as they fall due in the ordinary course of business.

   c. TEIs to have a treasury management policy that has been informed by experts in the field and that appropriately manages risk.

   d. That liquidity risks and mitigations are regularly reviewed by management and reported to Council.

   e. That if a TEI is forecasting to exceed available liquidity at any time, then it should immediately engage with the TEC in order to understand the associated risks and any available mitigations.

The TEC assesses this expectation through:

- engagement with senior management and finance personnel
- analysis of financial and cash forecasts
- the FMF
- analysis of Council sub-committee and Council papers (where applicable).

5. **A clear view of what a long-term sustainable level of debt is (if any) and what shorter-term debt levels are appropriate when compared to its financial performance.** In general, the TEC expects TEIs to:

   a. Ensure that levels of debt and the associated interest charges are not adversely impacting on the TEI's ability to deliver on its strategy and appropriately manage risk.

   b. Maintain a sustainable level of debt (if needed) that are consistent with their profitability forecasts and remain affordable under downside scenarios.

   c. Ensure debt limits do not exceed 3x earnings before interest, taxes, depreciation and amortisation (EBITDA), unless in exceptional circumstances. In general, the TEC considers that debt levels above 3x EBITDA carry an elevated risk.

   d. Have a clear plan for how debt will be repaid, including if financial performance deteriorates. This could include the need for possible asset sales, in which case the TEI should have a clear understanding of any

operational or educational impacts that may arise due to a sale and how these would be mitigated.

e. Only access debt facilities for liquidity purposes and strategic or capital asset investment. TEIs should not use debt to fund day-to-day operational expenditure, which should be funded from free cash flow.

The TEC assesses this expectation through:

- engagement with senior management and finance personnel
- analysis of financial and cash/debt forecasts
- the FMF
- borrowing consent applications and any agreed monitoring requirements
- the analysis of Council sub-committee and Council papers (where applicable).

6. **Adequate Capital Asset Management (CAM) systems and processes in place to enable capital assets to be managed and maintained effectively whilst ensuring individual investments and long-term priorities are aligned in the most cost-effective way to protect Crown assets.** The TEC expects TEIs to:

   a. Maintain a capital plan that is financially affordable and aligned to their institutional strategy. We expect the Council to regularly review and critically assess both short-term and long-term capital plans.

   b. Follow the Government's expectations for delivering major capital projects, and for the management of capital assets by participating in independent and self-assessment of CAM capabilities.

   c. Ensure robust, forward capital planning through their 10-year Capital Intentions Plan and establish the collection and monitoring of Asset Performance Indicators via this plan.

   d. Achieve a minimum rating of "core" as required for Tier 2 investment-intensive agencies, which the TEI sector is classified as, in their annual CAM maturity assessments (self-assessments and independent assessments).

   e. Continually work towards achieving CAM target scores set by independent assessors biennial as part of the independent assessment process, which will be based on several characteristics.[2]

   f. Regularly review the utilisation of real estate assets in line with enrolments, funding and the cost of ownership to leverage maximum potential. This should consider geographic diversity, disposal strategies and development strategies.

[2] These characteristics could cover elements such as EFTS (to assess capacity), General Floor Area (GFA), asset values, condition of assets, type of facilities, range of delivery offered, coverage, capital intention and asset management plans, in addition to soft indicators such as leadership commitment, capability and supporting systems (eg, asset registers, facilities management systems etc).

The TEC assesses this expectation through:

- engagement with senior management, finance, and estates/property personnel
- analysis of financial forecasts
- analysis of annual capital intention plans and annual CAM capability assessments
- borrowing consent applications and any agreed monitoring requirements
- analysis of Council sub-committee and Council papers (where applicable).

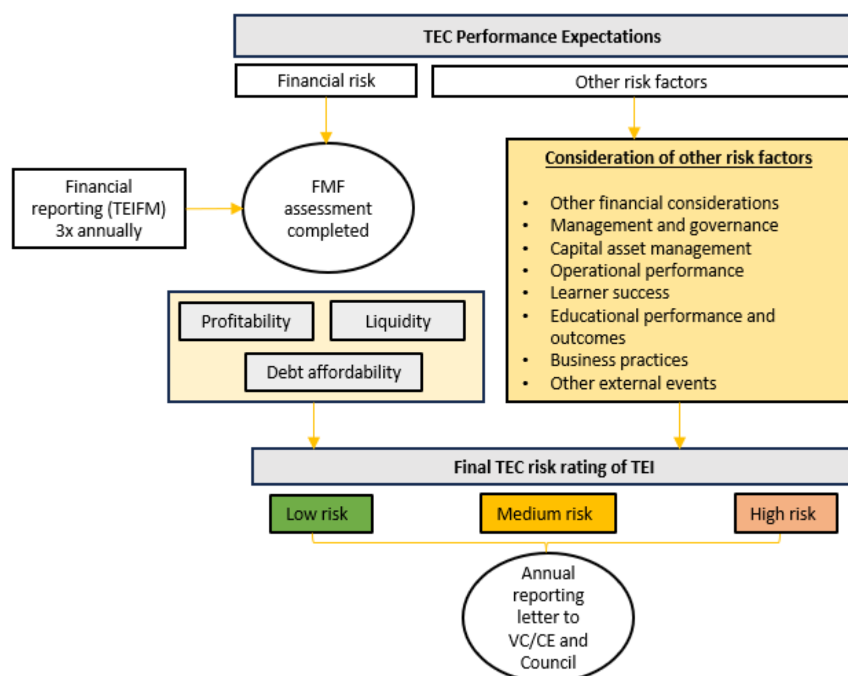
The risk assessment process

We use a range of quantitative and qualitative information to assess TEI performance against our expectations. Financial risk is assessed using both the FMF (refer to Appendix 1 for detailed information) – which provides risk assessments across three dimensions – and other financial information and analysis. We then use all other information available to us (including any information gained through engaging with TEIs)[3] to assess operational, educational, management and governance risks. Using both the FMF and other information, we then determine an overall risk rating for each TEI. This process is set out in Figure 1.

In practice, this could mean that a TEI has a low-risk rating across all three financial metrics in the FMF (profitability, liquidity and debt affordability) but receives an overall risk rating of medium or high risk based on other considerations (eg, poor financial forecasting accuracy, optimistic enrolment forecasts, management turnover). Alternatively, a TEI may be high risk on some dimensions of the FMF but have a lower overall risk rating when other considerations are made (eg, an upcoming asset sale or agreed insurance settlement, strong management and governance capability, or having recently implemented a successful restructure to achieve operating savings).

[3] The TEC does not consider a TEI's information in isolation. Each TEI's information is considered alongside broader sector trends, the position of other TEIs, and other environmental or contextual factors.

Figure 1: The TEC's risk assessment process



Annual reporting letter to each TEI stating the TEC's overall risk assessment

Following the May TEI Financial Monitoring (TEIFM) submission (which is when we receive the audited financial statements for each TEI and a reforecast of in-year performance), we will formally write to the management and Council of each TEI outlining both the FMF risk ratings and our overall risk rating. We will set out the key factors and risks we considered as part of determining your overall risk rating (particularly where the rating is medium or high).

Where a TEI is considered medium or high risk, we will engage with its senior management on how we arrived at this assessment and seek a response to how the risk is being managed and responded to. The response will then inform our ongoing monitoring activity.

Our approach to monitoring and assessing risk

Our general approach to monitoring overall TEI performance and assessing its risk level is underpinned by constructive engagement and, ideally, the mutual sharing of information and insights. One of our key aims is to understand the nuances of an institution's operations and its strategic objectives so that we can monitor risk effectively, and appropriately advise the Minister responsible for tertiary education and the TEC Board on those risks.

In instances where a TEI is considered high risk, this may include advising on the potential use of interventions by either the TEC Chief Executive or the Minister to manage risks to the Crown and New Zealand's tertiary education system.

Appendix 1: The Financial Monitoring Framework

The FMF is a technical tool that ensures a consistent and transparent approach to assessing each institution's viability and performance. The FMF relies upon audited financial statements and administrative financial information to undertake formulaic risk calculations for profitability, liquidity and debt affordability.

The profitability, liquidity and debt affordability risk dimensions are stand-alone tests. This means that a low-, medium- or high-risk rating is produced for each dimension. The FMF ratings are key inputs into the TEC's overall risk rating.

The TEC will calculate the FMF risk ratings against the TEIFM returns submitted in February, May and September each year. We will formally write to TEIs after the May return outlining both the FMF risk ratings and our overall risk rating.

The FMF tests

Profitability

Profitability provides a basis for understanding the viability of an institution's continued operations, reflecting whether its revenue and cost structures enable it to sustain its position and/or continue to grow. While there are a variety of common profitability metrics available, the FMF uses three:

1. **Operating surplus/deficit before trust and abnormal items to income:** This measure considers whether revenue covers expenditure for normal annual operations (which includes capital-related expenditure and interest). The size of this surplus or deficit compared to total annual income gives an indication of how efficiently resources are being used within an institution.
2. **Operating surplus/deficit after trust and abnormal items to total income:** This measure is similar to the above metric but includes abnormal and trust items within the calculation of the surplus/deficit. This recognises that some institutions have other activities or items that are outside their normal operations, but which can have a positive or negative impact on viability.
3. **Core earnings:** This measure considers the financial performance of the core operational activities of an institution and excludes capital-related and interest costs. This is calculated by considering the ratio of EBITDA to total income.

Liquidity

The liquidity test provides visibility on how easily an institution can meet its short-term obligations or withstand unexpected financial shocks. The framework uses two indicators to evaluate the adequacy of an institution's liquidity buffers:

1. **Liquid funds ratio:** This measure is a direct reflection of an institution's ability to pay operational costs and short-term debt obligations. It is calculated by considering liquid assets less short-term overdrafts to cash outflow (payments) from operations.
2. **Net cashflow from operations:** This measure provides an indication of an institution's ability to generate cash from normal operating activities. The measure is calculated by subtracting the cash outflows from operations from the cash inflows.

Debt affordability

The debt affordability test provides a medium- to long-term view on an institution's debt levels and its ability to meet those debt obligations. It considers both the balance-sheet strength of an institution and the ability of its operational performance to service debt on the balance sheet. The framework has three metrics to evaluate the debt held by an institution:

1. **Relative debt level:** This measure provides an indication of how much debt an institution holds relative to its profitability. This compares an institution's total debt to its EBITDA, reflecting how operational activities can be used to address debt obligations.
2. **Interest strain:** This is a relative measure that depicts interest repayments as a percentage of an institution's total revenue. It is calculated by comparing the annual interest paid on debt to total annual revenue.
3. **Debt–equity ratio:** This measure assesses the size of an entity's debt levels compared to the overall size of the institution's balance sheet. It is calculated by comparing total debt to total debt plus equity.

For clarity, low debt-affordability risk does not automatically mean TEIs will be able to obtain larger borrowing consent limits. The standard considerations will still be assessed as part of borrowing consent applications.

How the FMF works – assessment calculations

The FMF undertakes the quantitative assessment through the following three steps.

Step 1: Calculate a percentage or ratio for each measure

There are eight performance measures:

› three profitability measures;
› two liquidity measures; and
› three debt affordability measures.

A percentage (or ratio) is calculated for each of the performance measures over five financial years:

› two historical years;
› the current year; and
› two forecast years.

The values for each year are calculated as a weighted average over this five-year period, with specific weightings applied to each of these five years relative to the current year and the dimension that the measure relates to. For example, profitability measures have the following weighting profiles:

- 10 percent for the second historical year
- 20 percent for the first historical year
- 40 percent for the current year
- 20 percent for the first forecast year, and
- 10 percent for the second forecast year.

For example, if the current year was 2024, the profitability measure captures the, 2022 actual (10%), 2023 actual (20%), 2024 budget (or reforecast if prepared) (40%), 2025 forecasts (20%) and 2026 forecasts (10%). This relative year weighting allows historical and out-year forecasts to be considered while retaining a high emphasis on the current performance of the institution.

Liquidity and debt affordability measures place a greater emphasis on forecast years than historical years. The weighting profile for the liquidity and debt affordability measures is:

- 0 percent for the second historical year
- 20 percent for the first historical year
- 40 percent for the current year
- 25 percent for the first forecast year, and
- 15 percent for the second forecast year.

Step 2: Convert each measure's percentage/ratio, for each year, to a score between zero and five

This step sees the weighted average measure converted into a score between 0 and 5. Scoring criteria have been set using both current sector averages and historical data, and have been specifically determined for each measure. The following outlines scoring outcomes for the measures:

- A score below 2 is considered **high risk**.
- A score between 2 and 3 is considered **medium risk**.
- A score above 3 is considered **low risk**.

The tables below provide a definition and the scoring bands for each measure.

Table 1: Profitability scoring

Measure	Definition/calculation	Scoring table performance bands					
		0	1.0	2.0	3.0	4.0	5.0
Operating surplus/deficit before trust and abnormal items	Operating surplus/deficit before net trust and abnormal items **to** total income less net trust income	< -4%	-4% to 0%	0% to 2%	2% to 4%	4% to 6%	6% +
Operating surplus/deficit after trust and abnormal items	Operating surplus/deficit after trust and abnormal items **to** total income	< -4%	-4% to 0%	0% to 2%	2% to 4%	4% to 6%	6% +
Core earnings	EBITDA to total income	< 4%	4% to 9%	9% to 11%	11% to 13%	13% to 15%	15% +

Table 2: Liquidity scoring

Measure	Definition/calculation	Scoring table performance bands					
		0	1.0	2.0	3.0	4.0	5.0
Liquid funds ratio	Liquid assets and undrawn borrowings less short-term overdrafts **to** cash outflows (payments) from operations	< 5%	5% to 10%	10% to 15%	15% to 20%	20% to 25%	25% +
Net cash flow from operations	Cash inflows (receipts) from operations **to** cash outflows (payments) from operations	< 104%	104% to 108%	108% to 111%	111% to 113%	113% to 115%	115% +

Table 3: Debt affordability scoring

Measure	Definition/calculation	Scoring table performance bands					
		0	1.0	2.0	3.0	4.0	5.0
Relative debt level	Total debt **to** EBITDA	>4.0	3.0 to 4.0	2.0 to 3.0	1.5 to 2.0	0 to 1.5	0
Interest strain	Interest paid **to** revenue	> 3%	3% to 2.25%	2.25% to 1.5%	1.5% to 0.75%	0.75% to 0%	< 0%
Debt–equity ratio	Total debt **to** total debt plus equity	25% +	15% to 25%	7.5% to 15%	0% to 7.5%	0%	0% and 12% + Core Earnings

Step 3: Weighting the dimension measures

Within each dimension (ie, profitability, liquidity, debt affordability) each specific measure has been given a weighting to place additional emphasis on more important measures. For example, within the debt affordability dimension, greater emphasis is placed on an institution's relative debt level score (total debt to EBITDA) than interest strain or the debt–equity ratio. Table 4 below shows these relative weightings.

Table 4: Metric weightings

Dimensions					
Profitability		Liquidity		Debt affordability	
Measure	**Weighting**	**Measure**	**Weighting**	**Measure**	**Weighting**
Operating surplus/deficit before trust and abnormal items	30%	Liquid funds ratio	50%	Relative debt level	50%
Operating surplus/deficit after trust and abnormal items	20%	Net cash flow from operations	50%	Interest strain	25%
Core earnings	50%			Debt–equity ratio	25%

The final score for each dimension is the sum of each metric's score. As per the individual measure scoring, these dimension scores give values between zero and five. A score of three to five indicates low risk in that dimension. The following outlines scoring outcomes for the dimensions:

- A score below 2 is considered **high risk**.
- A score between 2 and 3 is considered **medium risk**.
- A score above 3 is considered **low risk**.