Preliminary speculations on a recent explosion of long-term financial liabilities at the University of Leicester

A report prepared for Leicester UCU

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Summary

In the light of recent news of (a) the University of Leicester executive board's 'Shaping for Excellence' plan (p.2, below), that we're told will likely involve compulsory redundancies, and (b) 'problems' that appear effectively to be breaching of financial covenants with three of the University's five creditors (p.6 below), we examine our employer's 'long-term strategy' and situate it in the context of financial performance and decision-making over the past few years. Our principal findings are as follows. Some necessarily involve a degree of conjecture given that much key information is private.

- *In 2016/17, the University effectively breached loan covenants with Barclays and the European Investment Bank. Leaders' response was to move to* ***increase*** *indebtedness by two-thirds, taking on an additional £55m of debt with two US insurance funds, Lincoln National Life and Pacific Life. (p.2 below)*
- *In 2018/19, decision-makers agreed to the creation of a 'special purpose vehicle' – Freemens Common Village LLP – leveraging some of this new debt to take on further long-term liabilities of £124m. Because of the financial engineering involved ('securitisation') this £124m is 'off balance sheet'. This £124m funds new student accommodation, teaching facilities and a carpark on the site. The underlying investment is rated as risky (BBB– according to ratings agency S&P); yet the bonds held by investors have a rating of AA. Such a de-risking (from the perspective of investors) can only be achieved, we hypothesise, by transferring equivalent risk to the University and its stakeholders. A consequence of this transaction is that investors may have indirect rights to intervene in the setting of future rents and service charges and that the University will guarantee certain minimum occupancy levels. It may even be possible that, in the event of default, the University would forfeit the control of the Freemen's Common site to investors. (pp.3-5 below)*
- *Including the off-balance sheet Freemen's Common project, the University's long-term financial liabilities now total almost* ***one-quarter of a billion pounds****. (p.7 below)*
- *In 2017, Council 'confirmed ... its willingness to accept and encourage an increased degree of risk in pursuit of the University's mission and objectives'. However we're unaware of students, staff and other stakeholders being informed of this new, more risk-loving, approach to our activities; still less can we find trace of them being consulted as to their views on its appropriateness. (pp.8-9 below)*
- *In 2020, the University again stands in what appears to be effective breach of covenants, this time with three of its five lenders. We do not know which creditors, nor the terms of the covenants, but it is possible one or more of these creditors now has the right to demand a role in the governance of the University.(p.6 below)*
- *We raise questions about the roles played in the above by three key decision-makers, viz., the current Deputy Vice-Chancellor, the current Chief Operating Officer and the current Chair of Council; and in the light of this we thus also have concerns regarding the appropriateness of the University's governance structures and the ways in which responsibilities have been enacted within them. (pp.7-8 below).*

Introduction

Employees of the University of Leicester first learned of their executive board's 'Shaping for Excellence' plan on 13 October 2020. In his email to all staff the current vice-chancellor explained that, 'These proposed changes underpin our long-term strategy for the University and are not determined by this year's financial position, which remains challenging.'

In this report, we examine the university's currently enacted 'long-term strategy' and situate it in the context of the University's financial performance and some of its leaders' conduct over the past few years. To do this we draw on the limited set of documents that are available to us, namely the University's annual financial statements and the unreserved minutes of its Council. Our observations are necessarily preliminary and partly conjectural because much of the detail that would permit a fuller understanding of what has transpired - and why - is not publicly available; which is also one of our substantive concerns. We hope to find out more as we continue our investigations.

Capital dreams and the highly indebted university

Let's begin with this from the November 2016 meeting of the University's Council:

> Council considered proposed changes to the terms of the University's three loan funding facilities with Barclays Bank. The changes were set out in three Amendment Letters from the Bank, designed to allow the University's exceptional restructuring costs to be excluded from loan covenant calculations for one year only ending on 31 July 2017. Without such exclusions the University would breech [sic] its Debt Service Ratio in that year, and this could lead to a qualified audit opinion in the 2016 Financial Statements. A similar issue had arisen with the terms of the University's loan funding facility with the European Investment Bank, but the EIB had indicated that it would waive the testing of the covenant for the year ending 31 July 2017. (Council meeting of 16th November; Minute16/M86)

We learn from this Council minute that in 2016 the University of Leicester effectively breached what are known as 'loan covenants' with two of its three principal creditors. The covenants attached to a loan exist for a very good reason, namely, to ensure that the borrower remains in a position to maintain the payments to the lender. To that extent, they are protection for both and not a mere technicality to be 'got round' by clever financial engineering. We also learn from this minute that University leaders sought and were granted a temporary exemption from these covenants for the year 2016–17, on the grounds of 'exceptional restructuring costs'.

What happened next is instructive. A naïve observer might think that the best thing to have done in this situation – having effectively breached loan covenants but enjoying a one-year period of grace in terms of the consequences – might be to quickly get one's borrowing under control. Specifically, to take steps to ensure the University's financial and broader institutional conduct once more conformed to the constraints stipulated by the loan agreements. One might have thought that a leadership team focused on ensuring it delivered its responsibilities with the utmost probity would be concerned about that.

However, this is not what transpired. The University of Leicester's senior leadership team seem instead to have decided that the best way forward would be to swell overall long term borrowing, initially by £52 million. The entirety of this increased debt – in fact more than its entirety –is accounted for by three so-called 'private placements' with two US insurance funds, Lincoln National Life and Pacific Life: these total just shy of £55 million. Private placements require no prospectus and are very hard to subject to any scrutiny, since their terms are, essentially, private. Unsurprisingly, the University's interest payment commitments also leapt at this point, by approximately 50%, from roughly £3m each year up until 2017/18, to around £4.5m per annum after that.

University of Leicester, long-term debt
(*Source:* Financial Statements, various years)

Year	Total debt, £m	Principal creditors
2014/15	80.224	Barclays, European Investment Bank, Salix, NatWest
2015/16	78.462	Barclays, European Investment Bank, Salix
2016/17	76.050	Barclays, European Investment Bank, Salix
2017/18	73.187	Barclays, European Investment Bank, Salix
2018/19	125.268	Barclays, European Investment Bank, Salix, Lincoln National Life, Pacific Life

Presumably this additional debt was incurred in order to begin to fund the University's £500m capital investment programme, announced in October 2017. This includes spending on the Brookfield campus, the redevelopment of the Percy Gee building and the new Space Park. Some of this seems to have been quite reasonably applied. It has funded the development of new or improved facilities from which we might derive some enhanced future financial returns, in order to both service our increased interest payment requirements and deliver further surplus for investment. On the other hand, some of the new commitments have involved the University in joint endeavours in which we seem to bear the lion's share of the potential risk, whilst private investors garner the lion's share of potential benefits.

In particular, a portion of the new debt seems to have performed a more convoluted role in the funding of the developments at Freemen's Common. These, note 27 to the 2018/19 accounts tell us, are part of an off-balance sheet transaction:

> On 2 August 2019 the University entered into a 50 year agreement with a consortium including Equitix Ltd (an investment company) and Engie (a constructor). The consortium will design, build, fund, manage and operate new residences built on the Freemen's Common site which will include 1,164 new bedrooms. The consortium will also build non-residential buildings including a multi-story [sic] car park, a cafe, an academic building, two squares and other non-residential buildings. Building works commenced in September 2019 and will take three years to complete. This is considered to be an off-balance sheet transaction as the special purpose vehicle "Freemen's Common Village LLP"[1] (of which the University will be a 10% partner) will be funding the project via a mixture of debt and equity. At 31 July 2019 the University held £16.5 million cash in an escrow account in relation to the transaction.

This is how the deal is represented by the investment company, verbatim:

> In July 2019, Equitix reached financial close on a 50 year project for the design, build, finance and operation of 1,164 room of student accommodation in partnership with the University of Leicester. The contract was awarded by the University in September 2017 to the Equitix-led consortium.
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> The project will provide 1,164 student rooms plus associated communal areas. The project is to be constructions [sic – we believe the word they were looking for was 'funded'] by a

[1] In the University's financial accounts the SPV is rendered as 'Freemen's Common Village LLP'. In its filings with Companies House it formally appears as 'Freemens Common Village LLP', which is why our rendering also shifts to try to keep up. As you'll note, University/university is all over the place in both our account and the texts we draw. We haven't even tried to tidy that up.

special purpose vehicle which is 80% owned by Equitix, 10% by Engie and the University will also own 10%.

All principle development and construction obligations have been subcontracted out to the Construction Contractor for a fixed price. The construction programme is 39 months delivering 424 rooms in Sep'21 and 614 in Sep'22.

Service obligations have also been passed down under an operating contract to Engie Services Limited with the University providing the soft FM [facilities management]. (https://equitix.co.uk/portfolio/university-of-leicester-student-accommodation/)

The apparent shape of this deal rings alarm bells with us. But it's very hard to know far our concerns are justified when the University leadership seems continuingly unwilling or unable to make available to students, staff and other potentially deeply impacted stakeholders any of the minutes of any of the committees one might think would be responsible for oversight of this sort of thing.

The magic of securitisation

Securitisation is a particular form of financial engineering, a way in which an entity – a corporation or indeed a university – may raise capital. It involves selling to investors part of the anticipated income from an asset and using and the money thus received to purchase (or build) the asset in the first place. An income stream treated in this fashion is said to have been securitised. Naturally, the investors will require some collateral to insure themselves against any shortfall in the hoped-for income stream. Normally this will include the asset for which they are providing the funds, but, in the case of buildings, it may also include the land on which they are built. This is the case with the University of Leicester's recourse to this method of raising capital

Companies House records tell us that in August 2019 Freemens Common Village LLP signed a charge in favour of BNY [Bank of New York] Mellon Corporate Trustee Services Ltd regarding one folio of land – LT429687 – and parts of three further folios of land: LT45010, LT259361 and LT290778. This land is better known to us as University of Leicester Residential Accommodation at the Dry Dock, The Library Store Sites and Freemen's Common Houses, Leicester LE1 7RH.

BNY Mellon Corporate Trustee Services Ltd often engages in these sorts of deals. Here it functions as 'security trustee'. What this means is that Freemens Common Village LLP will be subject to certain 'enforcement events' if it allows certain 'events of default' to occur. Precisely what these events are, we don't know, because they are specified in a senior finance document to which we do not have access. What we do know, however, is that both defaults and enforcement are financial in nature and will culminate in the handover of the property to the trustees if lesser remedies are not forthcoming. In other words that part of the University's estate has become collateral for the financial obligations of Freemens Common Village LLP to the trustees.

This particular deal seems also to have involved two new shell companies of the University of Leicester, both incorporated in 2018. One is an entity entitled UOL Investments Ltd; the other is called UOL FC Ltd. The former of these, Companies House tells us, is currently directed by the University's current Chief Operating Officer and its current Chief Financial Officer. The latter also appears to be directed by our current Chief Operating Officer and our current Chief Financial Officer and it acts as a designated corporate member of the Freemens Common Village LLP. The two new companies are first mentioned in the University's financial statements of 2017/8 and appear again in 2018/9, but given their significance in the University's future, the mode of their rendering there is absurdly muted. We're simply told that they are 'Not trading'. Well they weren't then. They appear to be more active now.

Some information is available elsewhere, however. From a press release from a Bermuda-headquartered insurance operation we learn the following:

> Assured Guaranty (Europe) plc (AGE) announced that it has guaranteed principal and interest payments on £124 million of bonds issued by Freemens Common Village LLP. The bond issuance will finance the construction of new student accommodation at the University of Leicester (the University). As a result of the guarantee from AGE, the bonds are rated AA by S&P Global Ratings. The underlying project is rated BBB–.
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> The 45-year inflation-linked bond, which reached financial close on 2 August 2019, took advantage of low long-term rates and was issued as a private placement to UK investors.
>
> The bonds will finance a total of 1,164 new bedspaces for university students, a multi-storey car park and new teaching facilities. The halls are located on campus and are designed to house both undergraduate and postgraduate students in a wide mix of room types including en-suites, studios, micro rooms and townhouse units.
>
> Engie Regeneration Limited (Engie) will build and maintain the halls through wholly owned subsidiaries, delivering the accommodation in two phases over three years. Equitix is the main sponsor of the project company, with Engie as a co-sponsor. The University has a 10% stake in the project company.
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> Dominic Nathan, Managing Director, AGE, commented:
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> "We are delighted to have closed another student accommodation financing, further demonstrating our ability to add value in this sector. Our wrapped bond solution, with long maturities and inflation-linked debt, continues to provide an efficient form of financing for projects of this type. Investors are attracted by the high rating we provide to the bonds and the associated low capital charges, as well as the efficient asset-liability matching this type of investment can provide."
>
> AGE guarantees timely payment of scheduled principal and interest to bondholders throughout the life of the bonds, in accordance with the terms of its financial guarantees.

Again, we need to pause to consider the implications of what we're looking at here.

The University of Leicester has committed something in the order of £16 million to an 'escrow account' to enable the 'off balance sheet' financing of the Freemen's Common development to go ahead. (This we mentioned above: it's in note 27 to the 2018/19 accounts.) An escrow account is a bit like the scheme through which security deposits for rental accommodation are held independently for the duration of the rental contract. In our case, the University of Leicester's £16 million is ameliorating the risk of investors' potential losses in the Freemen's Common project.

The press release from Assured Guaranty (Europe) contains one specific claim that we must pay particular attention to: 'the bonds are rated AA by S&P Global Ratings. The underlying project is rated BBB–'. In the nomenclature of the S&P ratings agency, BBB– is the 'lower medium grade', it's the lowest, i.e. the most risky, of 'investment grade' ratings, just one ranking above so-called non-investment grade assets, commonly known as 'junk bonds'. Yet, by some financial alchemy, this lower-medium risk project has been transformed into a 'high grade' investment for Assured Guaranty's clients. This can mean only one thing: somebody, somewhere is absorbing the real risks attendant on the project before any investment opportunity is presented to potential investors.

Again, there is an absence of documentation in the public domain – the bonds, like the debt that enabled the university to participate in the set up that issued them, are all private placements. Therefore, our ability to understand the specifics of the deal is limited and we must speculate. But our best guess is that it is the University of Leicester that has absorbed that risk gap. We make this assessment on the basis that the University appears to be the only party to the deal that has any capacity to generate the real underlying financial flows necessary to pay for the financial obligations

attendant upon it. The risk may have been trammelled by us paying the premiums of insurance upon it and/or it may be through other contractual guarantees.

The Freemens Common Village LLP is a so-called 'special purpose vehicle'. The £124 million worth of bonds issued through this special purpose vehicle are repayable over 45 years at an undisclosed, but index-linked rate of interest and, importantly, are 'asset-wrapped'. The assets in question are Freemen's Common itself – the land and any buildings thereon. In the event of default on the part of the borrower, Freemens Common Village LLP, these will be forfeited to the bondholders via the 'security trustee' we met earlier, BNY Mellon Corporate Trustee Services Ltd. The precise conditions under which the Freemen's Common estate will be forfeit to the trustees acting for the bondholders are not in the public domain. However, documents from various insurers and consultants involved in the transaction make it clear that the SPV will be required to set student rents at a level which will service the bonds and pay for the maintenance of the accommodation at a level competitive with the local market. The University, for its part, will need to deliver sufficient numbers of its students to maintain a specified occupancy level.

In some ways, this is a piece of clever financial engineering. Its 'cleverness' lies in the fact that the £124 million is not, technically speaking, a loan taken out by the University of Leicester. It does not, therefore, need to appear as a liability on its balance-sheet and does not consequently breach its existing loan covenants. It is, as the Financial Statements for 2018/19 are at pains to point out, 'off balance-sheet'. It remains the case, however, that the only income with which Freemens Common Village LLP will be able to service its £124 million debt will come from its student residences, shops and teaching facilities.

Whilst University leaders can truthfully claim that the assets placed at hazard in order to access this finance, namely the Freemen's Common estate, are those of the special purpose vehicle rather than itself, this is only the case because a charge on them has been provided by the university to the SPV as a preliminary to the issue of bonds.

'Once more unto the breach'

As part of the VC & Executive Board Live Q&A on 27th October, we learned from the Chief Operating Officer (the section of interest in the recording is at about 31 minutes in) that the University currently has 'problems' with three of its five lenders, which appear to be effectively breaches of covenants. As with the covenants that were effectively breached in 2016/17, there is nothing in the public domain that might indicate the terms of those covenants, which term(s) has/have been breached, nor even which creditors the University is in breach with. Officers of Leicester UCU have requested on at least two occasions details of the University's covenants, but the Chief Operating Officer has declined to provide these.

Once again, we resort to speculation. As we explained above, a Structural Protections Covenant ('covenant') exists to protect the debtor and, in particular, the creditor. A covenant is designed to act as an early warning system, notifying creditors when their investment is deteriorating or under stress. There are two varieties, negative and positive. Negative covenants prohibit the debtor from taking certain steps, e.g., borrowing above a certain defined level. Affirmative covenants require the borrower to perform certain activities, e.g. to maintain an 'adequate' ratio of cash flow to fixed charges. The 'robustness' of the covenant package typically depends on the 'quality' or credit-worthiness of the borrower.

Importantly for the situation the University of Leicester's leaders have got themselves – and us – into, when a company or institution is in danger of breaching, or has already breached, a covenant, US private placement lenders (such as Lincoln National Life and Pacific Life) are likely to demand 'a seat at the table', i.e. a role in the governance of the institution. Could this be a possibility for us?

It is important that we disentangle as much as we can of the University's longer-term financial situation from short-term stresses triggered by COVID-19. This is the point made by the vice-chancellor in the assertion, quoted at the beginning, that the executive board's 'proposed changes underpin our long-term strategy for the University and are not determined by this year's financial position, which remains challenging'. We know, for instance – from the Council minutes of 23rd April this year (minute 20/M22) – that a further £20 million in overdraft facility has recently been taken up to deal with the immediate cash consequences of the current pandemic.

But when we strip out this presumably short-term 'emergency' borrowing, the longer-term direction of the University's financial 'strategy' seems clear.

At some point in 2016 the University of Leicester was in breach of some of the terms of some of £76 million of borrowing. Rather than responding to that by directly addressing the behaviours that were taking us into breach of terms, a decision was taken to wildly extend the borrowing. Four years later, we are looking at being on the hook for something like a quarter of a billion pounds in long-term liabilities, with half of this buried in financial engineering and legal arcanery that obscure its nature. And as part of this process, the University has sold off its rights to significant streams of the income that might have enabled the servicing of its ballooning debt and other liabilities.

From bouncing cheques to missing checks…

But surely an institution with charitable status, such as a university, with a clear role in the delivery of public benefit, must have mechanisms in place to guard against inappropriate decision making? And surely if oversight hadn't functioned as well as it might on occasion, role holders responsible would be swiftly moved on? Let's have a look at some roles, responsibilities and timelines to see.

The financial statements of 2018/9 tell us that it is Council that 'is the supreme governing body of our university' and that 'The role of the Chair of Council is separated from the role of our university's Chief Executive and Accountable Officer, the President and Vice-Chancellor.'

When the Freemen's Common Village LLP sprung into life on 2nd August 2019, we didn't have a permanent Vice-Chancellor. Instead our current Deputy Vice-Chancellor was Acting Vice-Chancellor, a role he held from April until November of 2019. At this point, he returned to his previous role of Deputy Vice-Chancellor to which he was appointed in July 2018.

The Chair of Council on 2nd August 2019 was our current Chair of Council. He took up that role the day before the special purpose vehicle set out on its long journey into our future. Immediately prior to becoming Chair of Council the role holder served as the University's Treasurer, a post he took up in August 2018. One of the duties of the Treasurer is to chair the University's Finance Committee, according to that committee's constitution and membership. The Finance Committee 'monitors the University's overall financial health, advises on overall financial strategy, and provides oversight of key campus and capital projects and programmes' as the corporate governance section of the financial statements remind us.

More specifically, according to its terms of reference, one of the responsibilities of the Finance Committee is to 'advise on borrowing policy, and to consider and approve proposals for borrowing and capital financing structures and related external funding arrangements, and the details of their terms, reporting as necessary to the Council.'

Finance Committee is kept in check by the Audit Committee, which 'provides oversight of the university's risk management, control and governance arrangements'. The two committees being kept strictly independent: 'No member of the Audit Committee may also be a member of the Finance Committee, unless Council makes a formal decision to allow one Audit Committee member to sit on both. This did not occur in 2018–19.' (See p. 22 of Financial Statements 2018/19.)

We don't know the precise make up of either of these committees since there seem to be no minutes of their business available to University staff, students or other stakeholders. Making at least the unreserved minutes of such committees public is, we contend, essential to enable the transparency that tends to keep bad decision making under control. But we can glean from the terms of reference, membership and constitution for 2019/20 that the Deputy Vice-Chancellor serves on the Finance Committee and the Chief Financial Officer is 'normally in attendance'. Both the Deputy Vice-Chancellor and Chief Financial Officer are also 'normally in attendance' at the Audit Committee.

The post of Chief Financial Officer came into existence in April 2019. Its first holder had previously been the University's Director of Finance; then the most senior finance role in the university's salaried staff hierarchy, a post he had held since November 2011. In February 2020, this inaugural CFO was appointed Chief Operating Officer, upon which he relinquished his position as CFO. The latter role is now held by the former deputy CFO.

In summary then, the current Chief Operating Officer, Deputy Vice-Chancellor and Chair of Council all either chaired, sat on or 'normally attended' the two key committees – Finance and Audit – that are formally and constitutionally responsible for providing oversight of the University's financial dealings. Specifically, these committees should have subjected the three private placement loans with two US insurers and the university's involvement in the Freemen's Common Village LLP to the closest of scrutiny. As we explained above, it is these three loans that have increased the University's long term-debt by about two thirds and it's the LLP that has, in practical terms, nearly doubled again the University's long term financial liability. It is the consequences of this range of financial exposure that we now seem to be struggling to service. It is in relation to various aspects of the formal 'debt' portion of this exposure that we suspect loan covenants have again been breached – potentially jeopardising our University's autonomy.

We have already drawn attention to the lack of appropriate transparency in regard to all of this – specifically the absence of any accessible minutes. Because of this, we cannot judge how individual office holders and decision makers exercised their respective roles or what concerns they may have considered in the process of doing so. Presumably the 'shaping for excellence' of our leadership and corporate governance at the university is still to come. As the Vice Chancellor's mail of 13th October highlighted, 'We can't be excellent at everything'.

All you can eat

At a meeting three years ago,

> Council confirmed its approval of the Risk Management Policy and the Risk Appetite Statement, and its willingness to accept and encourage an increased degree of risk in pursuit of the University's mission and objectives, whilst minimising exposure to compliance, brand and reputation, and overall financial risks. (Council meeting of 22nd November 2017; Minute17/M102)

A copy of a Risk Management Policy does appear on the website (it's here), but it's dated October 2015, i.e. a full two years before Council agreed that we could eat a little more. We can't find a more recent one anywhere. The issue is discussed again by the supreme governing body a year later.

> Council considered the latest versions of the University's Risk Management Policy and Risk Appetite Statement, noting that both documents had recently been reviewed and endorsed by ULT [University Leadership Team] and the Audit Committee as part of the risk assurance framework and process.
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> With regard to the Risk Appetite Statement, Council noted that it would be circulated more widely within the University to promote increased awareness of risk appetite, and the

possibility of describing more specifically the appetite for certain risks was also being explored. (Council meeting of 21st November 2018; Minute18/M116)

This 'Risk Appetite Statement' appears to have previously been approved by Senate at its meeting of 11th November 2017 (Minute 17/M12 (e), these are so well hidden you have to google to find them "University of Leicester" and "Risk Appetite Statement" brings it up) but we can find no trace of the statement itself. It appears that our University is being steered in a new, seemingly more hazardous direction but that the majority of its employees have been left unaware and unable to make themselves aware of this new course.

Concretely, we can say that our University's long-term financial liabilities have more than tripled over the course of four years – from roughly £76 million to roughly £250 million. Acquisition of this new level of long term liability has been overseen by the current holders of some of the University's most senior roles. It has already involved two financial 'incidents', when covenants with creditors have been effectively breached.

Yet all of the attendant risk associated with this new 'direction' is being force fed to current rank and file staff, in the form of potential loss of their livelihoods; and to future students, in the form of the increasing unaffordability of their rents. Indeed, it may even jeopardise continuing university control of the premises in which they come together, along with the institution's very autonomy.

It is absolutely unforgiveable that it seems that it is to be the university's ordinary members, its staff and its students, rather than the decision makers who took us to this situation, who look set to pay the price that the consequences of their decisions demand of us.