BEREA COLLEGE DEBT POLICY

A Means to Effectively Utilize and Manage Debt-Financing Resources for Capital Improvements and Renovations

Background

Debt financing allows the College to pay for an asset over a period of time, up to its useful life, rather than pay for it at the time of purchase. This is a financially responsible practice for certain types of investments within appropriate limitations and acceptable interest rates. Debt financing is financially beneficial if borrowing rates are below investment returns or if the College invests in capital assets which provide investment returns or cost savings which are greater than the cost of borrowing.

Objectives

1. To provide a guideline on the use of debt proceeds to support the College's capital needs while achieving the lowest overall cost of capital.

2. To provide selected financial ratios with specific targets to ensure the College continues to operate within appropriate financial parameters that enable the College to keep an Aaa credit rating as determined by Moody's Investors Service.

Financial Analysis

Principles for Structuring Debt Financing

1. The College will seek the lowest cost source of financing when issuing debt considered concurrently with the associated risk. For preservation of debt capacity and the security for debt financing, bonds will be used for College capital assets with the general obligation pledge of the institution as security.

2. A project can be financed if there is an identifiable repayment source (e.g., Capital Fund or residence hall revenues), and, where possible, an additional reserve fund or income from unrestricted resources, where intended repayment sources become unavailable.

3. Bond issues will be coordinated to the extent possible so that multiple projects can be accommodated in a single borrowing to reduce overall issuance cost per dollar of debt issued.

4. The timing of borrowings should be coordinated to avoid arbitrage rebate on construction or project funds.

5. Internal loans may be used for interim financing until long-term financing can be completed. A Reimbursement Resolution must be approved by the Board of Trustees as soon as the project is approved to facilitate this provision.

6. The College may issue fixed or variable rate financing. The use of variable rate debt instruments may be pursued when advantageous and beneficial to the College. Variable will only be considered when the short term liquid investment assets of the College can be pledged against the debt in the amount equal to the liquidity required by the rating agency in order to hedge against the interest rate risk of the borrowing. (Presently the rating agency requires 1.2x the principal of the debt.) Short-term liquid investment assets will be limited to cash and those investments identified in Berea College's Short Term Investment Policy for operational cash, i.e.; highly rated investment securities (based on type of the investment categories) with a maturity of less than one year.

   The College will evaluate three key risk categories associated with a bond offering to finance capital projects when considering the choice between a variable or fixed bond structure. Those include interest rate risk, tax risk and liquidity risk.

   - **Rate Risk** is the risk that short-term interest rates will increase beyond the College's debt service provisions, thereby taking resources away from other competing programs or uses.

   - **Tax Risk** is the risk that the premium received from being a tax exempt interest organization would be altered in some way by Federal tax cuts or changes in the basic tax structure.

   - **Liquidity or Funding Risk** is the possibility that buyers in the market would not be willing to buy the bonds being sold by current investors during the regular remarketing schedule. Therefore, the College would have to purchase those bonds when presented for sale on the market.

   Berea College will consider derivatives like Caps, Collars or swaps if market conditions surrounding an issue make it advantageous to the College when considering the risks and financial advantages to the College at the time. All derivative contracts must be approved by the Administrative Committee and the Board of Trustee Finance Committee before execution.

7. Berea College will actively consider current or advanced refunding opportunities of outstanding debt when the net present value savings are positive, and the refunding will support a strategic need of the College (i.e.; reduce debt service requirements in order to increase the debt capacity for additional projects.)

Debt Capacity Review

The College should seek to retain its Aaa Rating as assigned by Moody's Investors Service and its Moody rating when looking at strategic projects of the institution and the capacity the resources of the institution will provide to support the long-term debt service payments required. In an effort to meet Berea College's policy objectives, the College has established limits for overall debt using three ratios consistent with measures used by the rating agencies. It should be the goal of Berea College to strive for the most conservative end of these ratios to guard against economic downturns that have a negative effect on the financial position of the College.

Ratio #1

Viability Ratio = **Total Unrestricted & Temporarily Restricted Net Assets Less Net Investment in Plant (Over) Outstanding Debt**

This ratio measures the availability of assets, excluding permanently restricted net assets, to cover debt should the College be required to repay its outstanding obligations immediately. The target for this ratio is to be no less than 8 times to 11.5 times. This shows the College has enough unrestricted assets to pay for its outstanding principal debt more than 8 – 11.5 times. At the time the College is considering debt for the institution, it should strive to keep the ratio at 11.5 times or above to hedge against a negative effect on the financial statements of the College due to a downturn in the growth of the endowment.

Ratio #2

Debt Service to Operations = **Actual Debt Service (Over) Total Operating Revenues**

The debt service to operations ratio measures the percentage of debt service to the total annual operating revenues of the institution. By maintaining an appropriate proportion of debt service to total revenues, other critical and strategic needs can be met as part of the expense base. The target for this ratio is to be no greater than 8% - 12%. This ratio indicates the College is not spending excessive amounts of the operating funds on debt service instead of needed programs. At the time the College is considering debt for the institution, it should strive to keep the ratio at 8% of total operating revenues to hedge against a loss in revenues due to a downturn in the investment returns of the endowment.

The thresholds for these ratios are not to be exceeded without express approval from the Board of Trustees. Ratios will be evaluated on an annual basis. In addition, the ratios will be calculated to show the effect of a new bond issue before funding of a project is approved by the Board of Trustees.

<u>Debt Service Reserve for the Capital and Plant Fund</u>

As discussed in the Principles for Structuring Debt Financing (Principle #2), a project can be financed if there is an identifiable repayment source (e.g., Capital and Plant Fund or residence hall revenues) that is available. In the context of the Capital and Plant Fund, the Board of Trustees has articulated the following definition to guide a decision whether there are funds within the Capital and Plant Fund that are available to provide debt service for a project being funded, in whole or in part, through the issuance of bonds or other external debt of the College.

Overview of the Capital and Plant Fund

The Capital and Plant Fund was established in 1996-97 as a source of funding academic debt service and to fund one-time capital needs. The only source of revenue for the Capital and Plant Fund is endowment spendable return based on the approved endowment spending formula. Endowment units (shares) of unrestricted bequests that have been internally designated to support the Capital and Plant Fund serve as the endowment principal base on which the Capital and Plant Fund endowment spendable return is calculated.

Debt Service Reserve

As discussed above, the Capital and Plant Fund receives an annual allocation of endowment spendable return as its income source. Annual debt service (annual principal and interest payments) is charged to the fund. Prudent budgeting should incorporate a debt service reserve calculation within the Capital and Plant Fund in order to assure sufficient liquidity within the Capital and Plant Fund to service the debt being supported by that fund in the event the annual endowment spendable return is diminished due to declines in the market value of the College's endowment.

The debt service reserve is expressed as a percentage based on a calculation of the amount of annual Capital and Plant Fund endowment spendable return in excess of the annual required debt service divided by the annual Capital and Plant Fund endowment spendable return. The Board of Trustees has determined that a debt service reserve of thirty-five percent (35%) is to be maintained in the Capital and Plant Fund at the time of and after the issuance of any additional bonds or external debt of the College is being considered. Trustees should consider the debt service reserve percentage along with the Board's desire to maintain a Moody's Aaa rating and its other financial ratios as future determinations are made whether to borrow for capital purposes.

The following example illustrates a 35% debt service reserve:

Annual Capital and Plant Fund endowment spendable return	$4,000,000
Annual required debt service (existing principal and interest payments for Capital and Plant Fund Projects)	($2,600,000)
Difference	$1,400,000

Debt service reserve percent calculation:

$$\frac{\text{Difference from above} \quad \$1{,}400{,}000}{\text{Annual Capital and Plant Fund endowment spendable return} \quad \$4{,}000{,}000} = 35\%$$

Under this example, the debt service for existing projects relying on the Capital and Plant Fund as the source of funding leaves a 35% debt service reserve. No new projects relying on the issuance of external debt utilizing the Capital and Plant Fund as the source of funding should normally be undertaken until a time when the capacity of the Capital and Plant Fund improves to such an extent that the annual required debt service for all existing and new projects, taken together, leaves a 35% debt service reserve.

Action by the Board of Trustees:

Originally Adopted - October 25, 2003
Debt Service Reserve Amendment Adopted – May 14, 2005