

The Financial Downturn and Its Impact on Higher Education Institutions

**Prepared by the National Association of
College and University Business Officers (NACUBO)
in Partnership with the Association of
Governing Boards of Colleges and Universities (AGB)**

Colleges and universities are extraordinarily stable institutions, in part due to their mission and role in our society and in part due to how they operate and are managed. Nonetheless, the current financial downturn is impacting higher education institutions in a wide variety of ways.

The financial challenges described below are among the most pressing in recent times and will call on presidents, chief financial officers (CFOs) and boards to work together to address the near-term fiscal impact on the institution's operations as well as longer term consequences.

Following the narrative is a series of questions that decision makers are asking of themselves and colleagues as they work through the current uncertain environment. Not all questions will apply to every institution equally. However, effective oversight, management and stewardship mandate that institutional leaders are able to assure themselves and their constituencies that thorough analysis and full consideration have been applied in posing questions, providing answers and making decisions.

Institutional Liquidity

This fall, a number of forces collided almost simultaneously to produce concern on campuses throughout the country about the liquidity of institutional investments. In some cases institutions established or increased a line of credit. The changing state of institutional liquidity had in its roots several factors. Many colleges and universities experienced unexpected changes in the liquidity of their investments. Available distributions from some investments, including both long-term holdings (e.g., certain alternative investments such as hedge funds) and short-term investments (such as the Commonfund's Short Term Fund) may not have equaled institutional budget assumptions or expectations. In addition, institutions that have used variable rate bonds to finance infrastructure projects on campus saw in some cases sudden increases in their debt service payments, as the market for these bonds was buffeted by forces in the larger credit market.

Resources

Commonfund (www.commonfund.org)

Treasury Institute for Higher Education (www.treasuryinstitute.org)

National Association of College and University Business Officers (www.nacubo.org/x10870.xml)

This statement has been endorsed by the American Dental Education Association, the Council for Christian Colleges and Universities, the Council on Government Relations, EDUCAUSE, and the Women's College Coalition.

Long-Term Investments

After more than five years of solid growth in the value of college and university investments, primarily held in endowments, steep global market declines have erased a significant share of these gains. As of October 24, 2008, the Dow Jones Industrial Average was down more than 35 percent, the S&P 500 declined more than 39 percent, and the Russell 2000 fell almost 38 percent in 2008. Overseas markets have not fared any better. As a result, institutions are reviewing asset allocation strategies, re-examining investment manager selections, and scrutinizing investment portfolios. At the same time, college and university leaders continue to place their primary focus on the long-term success of investment management tactics and decisions.

Because many institutions base their endowment spending policies using a rule to smooth spending from one year to the next, a short-term drop in endowment values typically has a modest impact on spending. For example, a majority of participants in NACUBO's annual endowment study report using a rule that calls for spending a pre-specified percentage of a moving average of their endowment market value, either over the prior three fiscal years, or prior twelve quarters. As a result, a drop in market value in one quarter will, when included with market value from eleven other quarters, not exert an immediate downward pull on endowment spending.

Resources

National Association of College and University Business Officers (www.nacubo.org)
Commonfund (www.commonfund.org)

Long-Term Debt

The national and global economic crisis remains highly fluid and its impact on higher educational institutions will likely require many quarters, if not years, to appreciate fully. The quarter ending September 30th will likely be remembered as one of most tumultuous periods in the global financial system and credit and equity markets. What began as a liquidity and credit crisis evolved into a solvency crisis as financial institutions struggled (or were unable) to cover existing liabilities.

In light of the credit and debt environment, many universities are actively re-assessing the current structure of their debt portfolio. Some are drafting or revisiting their formal debt policy guidelines, as well as determining appropriate strategies for capital funding, leverage and liquidity management.

Institutions that were planning to borrow using tax-exempt bonds may have pulled back from or delayed issuing long-term debt due to increased interest rates and, for a period of time this fall, the virtual disappearance of a market for these bonds.

Looking ahead, some institutions may experience a ratings downgrade that can impact how they access the bond market. Some experts have suggested that those institutions with single-A ratings or lower may have to increase the types of bond covenants that are associated with their debt, adding more security features for investors. These additional covenants are likely to increase the total costs of the bond.

Most long-term bonds for higher education are issued with fixed interest rates. Typically, fixed interest rates are higher than variable rates, and this spread can be larger during periods of relatively low interest rates, as we have experienced in recent years. The principal advantage of fixed rate bonds is they allow an institution to more accurately predict and manage their debt service cost. While the institution may be paying a higher rate, the costs are not subject to short-term (in some cases, daily) fluctuations that come with variable rate instruments.

Some institutions have employed a special type of long-term bond called variable rate demand bonds (VRDB) to fund capital projects. VRDBs are actively traded in financial markets and are primarily purchased by tax-exempt money market funds. The interest rate on VRDBs is reset periodically (typically daily or weekly). In addition to the continually changing interest rates, bondholders also have the right to “tender” or “put” the bonds back to the borrower (e.g., daily or with seven days notice). Thus, there are primarily two kinds of risks associated with VRDBs. First, if investors in an institution’s bond decide to sell their interest and there are no buyers, the institution would be forced to buy the bond itself. Institutions usually have insurance for this eventuality. This happened to some institutions this fall. Second, the interest rate set each day depends on the demand for an institution’s bonds and that demand level depends on many factors, including investor confidence in an institution’s credit worthiness. As investors fled the credit markets this fall, interest rates on VRDBs spiked, in some cases reaching rates as high as 12 percent. This increase caused the debt service expense on these bonds to increase significantly and unexpectedly.

Resources

- Moody’s Investors Service (www.moodys.com)
- Standard and Poor’s (www.standardandpoors.com)
- The Bond Buyer (www.bondbuyer.com)
- The Securities Industry and Financial Markets Association (www.sifma.org)
- Association for Financial Professionals (www.afponline.org)
- Treasury Institute for Higher Education (www.treasuryinstitute.org)

State Appropriations

State and local government appropriations account for a significant portion of most public college and university budgets. In the aggregate, these appropriations account for slightly more than one quarter of the resources available for public colleges and universities to spend each year.

According to the State Higher Education Executive Officers (SHEEO), total state and local government support for higher education in 2007 was \$83.5 billion, a 7.7 percent increase in total funding over 2006 levels. On a per-student basis, funding in 2007 increased in constant dollars by 3.9 percent over 2006 levels. These increases follow several years of essentially flat public support, in the aggregate, of public colleges and universities. Between 2002 and 2005, total annual support averaged approximately \$70.75 billion, with relatively small variations from year to year.

Total State and Local Government Support (in billions)					
2002	2003	2004	2005	2006	2007
\$70.585	\$70.420	\$69.826	\$72.230	\$76.463	\$83.464

The data over the last five years illustrates the counter-cyclical nature of higher education. During periods of economic slowdown, two things generally happen: 1) enrollments levels tend to rise faster than during times of economic growth, and 2) state revenues decline, putting pressure on states to reduce expenditures, including support for higher education. Historically, state and local support for higher education has “rebounded” once the economic growth resumes, but there is often a significant delay. As illustrated in the table above, state and local funding took several years to recover from the economic slowdown that occurred in 2001-2002.

Illustrating the power of history repeating itself, current-year budget shortfalls have already occurred in the budgets of at least 27 states plus the District of Columbia, and the fiscal challenges facing the states are expected to continue at least into next year. At this time, at least 21 states have implemented or proposed cuts to public colleges and universities, with reductions ranging from 5 to 15 percent of previously appropriated funding.

Resources

State Higher Education Executive Officers (www.sheeo.org)
National Association of State Budget Officers (www.nasbo.org)
National Conference of State Legislatures (www.ncsl.org)
National Governors Association (www.nga.org)
Center on Budget and Policy Priorities (www.cbpp.org)
Rockefeller Institute of Government (<http://www.rockinst.org/>)

Fundraising

Historically, annual growth in the private philanthropic support of colleges and universities has been fairly modestly tempered by periods of economic slowdown, and promptly rebounded as the economy has strengthened. If we see this pattern replicated under current economic conditions, institutions may experience a temporary and modest slowdown in giving that is not likely to have a serious impact on colleges.

Resources

Council for Advancement and Support of Education (www.case.edu)
Boston College Center on Wealth and Philanthropy (www.bc.edu/research/cwp)
Indiana University Center on Philanthropy (www.philanthropy.iupui.edu)
Independent Sector (www.independentsector.org)

Balance Sheet Analysis

Since 1998, independent institutions must pass financial health standards to be eligible for Title IV federal student financial assistance programs. The financial health of institutions is assessed based on three ratios: primary reserve, equity and net income. An institution’s raw ratio scores are converted to strength factors and combined into a composite score. Although the full impact of the current economic turmoil is yet to be realized, liquidity and investment holding issues can impact key ratios used by the Department of Education to determine financial health, and thus eligibility to participate in the Title IV program.

The Council of Independent Colleges has a Key Indicators Tool (KIT) and Financial Indicators Tool (FIT). These benchmarking services provide valuable resources for presidents of small and mid-sized private colleges and universities to gauge institutional performance. The FIT, which is based on the Composite Financial Index (CFI) methodology, provides presidents with an overall measure of financial health, and component CFI ratios, including debt (viability ratio).

Resources

National Association of College and University Business Officers (www.nacubo.org)
Council of Independent Colleges (www.cic.org)
Council for Christian Colleges and Universities
(http://www.cccu.org/professional_development/resource_library/cccu_cfi_sample_report)

Financial Reporting and Disclosures

The fall 2008 timing of market declines and liquidity restrictions can have implications for financial statement audits in process. Higher education institutions that have not yet released audited financial statements will need to evaluate the correct balance sheet classification for cash and cash equivalents, possible subsequent event note disclosures, and losses to asset market values.

Resources

National Association of College and University Business Officers (www.nacubo.org)
Financial Accounting Standards Board (www.fasb.org)
American Institute of Certified Public Accountants (www.aicpa.org)

Enrollment Levels

Historically, enrollment on college and university campuses across the country has risen during periods of economic slowdowns, as people seek additional training and retraining, finish their degree, or advance their education. For example, fall enrollment at degree-granting institutions increased from 15.9 million in 2001 to 16.9 million in 2003. Similar enrollment increases occurred during the 1980-81 and 1990-91 recessions.

While final data is not yet available, preliminary indications suggest that student enrollment in our nation's colleges and universities this fall continued to grow, in part reflecting significant enrollment growth among community colleges across the country. However, institutions are carefully watching both spring enrollment, and applications for the incoming freshman class in the fall of 2009, for signs that the economic stress being placed on families will impact their decision to attend college, and whether there will be any market shifts towards lower cost colleges and universities.

Resources

U.S. Department of Education, National Center for Education Statistics, *Projections of Enrollment Statistics to 2017* (<http://nces.ed.gov/pubsearch/pubsinfo.asp?pubid=2008078>)

Student Loan Capital and Demand for Financial Aid

In the spring of 2008, there was concern about the availability of loan capital for the Federal Family Education Loan Program (FFELP), through which banks make federal student loans that are guaranteed by the federal government. This concern ultimately led Congress to enact legislation designed to stabilize the student loan market. While the legislation may well have had the desired effect, many colleges and universities had to work hard to ensure that they had loan provider options for their students, at a time when many financial institutions were reconsidering their participation in the federal student loan program. At the same time, the market for private student loans was perhaps more volatile. The College Board reports that the amounts students borrowed through private loan programs fell 1 percent, from \$19.2 billion to \$19.1 billion, between 2006-2007 and 2007-2008, and suggests that private loan volume has declined further in 2008-2009. According to a study conducted by the National Association of Independent Colleges and Universities (NAICU), “while there was no widespread student loan crisis through September, there were multiple instances of students taking time off of school, switching to part-time status, and turning to alternative forms of financial support than reported in NAICU's March survey.”

As a result, colleges and universities are increasingly turning to the Federal Direct Student Loan program in order to shield themselves from any further potential adverse impacts of the downturn in the credit markets. Under the Direct Loan program, federal student loan funds come directly from the federal government, rather than banks or other private lenders. The *Chronicle of Higher Education* has reported that dollar volume in the bank-based FFELP grew by 7 percent last year, compared with a 50 percent increase in direct lending. Direct Loans now account for about 30 percent of the total federal student loan volume, and there are some estimates that Direct Loans will make up a majority of federal students loan funds by fall 2009.

The concerns about federal loans were also coupled with increasing worry about the rising demand for institutionally funded financial aid. The NAICU survey found that about 75 percent of private colleges reported rising requests for institutionally based financial aid. Among those institutions that had experienced increasing demand for aid, 17 percent had made cuts to other areas of their budgets and shifted these funds into financial aid, and 11 percent drew additional funds from their endowments.

Indeed, colleges and universities appear to have been increasing their budgets for financial aid despite the challenging economic environment. The College Board's recently released “Trends in Student Aid” report reveals that the amount awarded for institutional aid increased by 8 percent—to more than \$29 billion—from academic year 2006-2007 to 2007-2008. In roughly the same period, tuition and fee prices rose by about 6 percent. Further, the College Board's data show that institutions now are the largest source of grant aid; institutional grants represented 42 percent of all grant aid, while federal grants were 31 percent of the total. In addition, NACUBO's Tuition Discounting Survey data show that more than 80 percent of all entering full-time first-time undergraduates receive an institutional grant award.

Rising institutional aid, combined with federal college tuition tax credits and increases in state and federal grant appropriations, suggest that a large number of students are paying less for college than the published tuition and fee charges indicate. The College Board estimates that in 2008-09, full-time students at independent colleges and universities receive an average of \$10,200 in grant aid from all sources and federal tax benefits. This aid reduces the average net tuition and

fee price that full-time undergraduates pay from the published “sticker price” of \$25,100 to about \$14,900. Full-time students attending four-year public colleges and universities receive an estimated average of \$3,700 in grant aid from all sources and federal tax benefits, which reduces their average tuition and fees they pay from the \$6,600 sticker price to about \$2,900.

The financing and financial aid trends suggest that colleges and universities continue to do all they can to hold down costs and increase aid to many financially needy students and their families. However, the economic downturn has temporarily erased a considerable amount of wealth due to falling stock markets, and the nation’s unemployment rate has risen in 2008 from 4.9 percent in January to 6.1 percent in September. The financial strains that families are feeling are significant, and are expected to lead to increased demand for financial aid from federal, state and institutional sources.

Resources

National Association of Independent Colleges and Universities (www.naicu.edu)

The College Board, *Trends in Student Aid* (www.collegeboard.org/trends)

National Association of State Student Grant and Aid Programs (www.nassgap.org)

National Association of Student Financial Aid Administrators (www.nasfaa.org)

NACUBO Tuition Discounting Survey (www.nacubo.org/x44.xml)

Campus Communications

College and university leaders play a key role in managing communications explaining how the financial downturn of the U.S. economy is affecting their campus. Timely, thoughtful, transparent and thorough communications to staff, faculty, alumni and students can allay fears and ease concerns – ultimately making a positive difference in how the institution is perceived. (Perception can affect admission numbers and fundraising for years to come.) Many campuses have already engaged in several methods to communicate their messages including president’s letters, FAQ’s, teleconferences, board meetings and seminars featuring economic professors from their institutions.

After reviewing several communications from various campuses, a number of consistent lessons can be drawn.

- **Clearly identify roles and responsibility** – Identify a point person to convene an issues management team from various areas of campus.
- **Segment communications** – “Everything isn’t for everybody.” Clarify who speaks to whom. Control your message and flow of information. Even the methods of delivery may vary -- messages to faculty and staff may be sent by e-mail; to students through text message; to alumni and donors via paper letter.
- **Monitor the response** – Review how your audiences are reacting to the message to help you learn about additional information they may need from you.
- **Use technology well** – Remain cognizant of how people use technology and how best to deploy various technology options. Consider a “lite” version of your homepage to facilitate faster load times when traffic spikes. Understanding your local network infrastructure and capacity is essential to effective use of technology.

The resource listing below includes examples from various institutions that may prove useful as campus leaders develop their communication plans.

Resources

Boston University President's Letter to Faculty and Staff:

<http://www.bu.edu/president/letters-writings/letters/2008/10-16/>

Brown University:

<http://www.brown.edu/Administration/President/letters/2008-2009/2008-financial.html>

Clemson University:

<http://www.clemson.edu/president/letters/100908.html>

University of South Carolina:

http://president.sc.edu/letter_10102008.php

Rutgers University:

<http://www.president.rutgers.edu/economy.shtml>

Colgate University:

<http://blogs.colgate.edu/2008/10/president-chopp-addresses-imp.html#more>

Seminar: <http://www.colgate.edu/DesktopDefault1.aspx?tabid=3555>

Cornell University:

<http://www.cornell.edu/president/speeches/20081017-state-of-university-address.cfm>

Georgetown University:

<http://explore.georgetown.edu/news/?DocumentID=36603>

Middlebury College:

<http://www.middlebury.edu/administration/budget/challenge/faq/>

http://www.middlebury.edu/about/president/addresses/100808_financial_challenges.htm

University of Pennsylvania:

<http://www.upenn.edu/pennnews/article.php?id=1465>

University of Miami:

http://www6.miami.edu/president/dialogue/dialogue_10_02_08.html

Emory University:

<http://www.emory.edu/home/news/releases/2008/10/emory-and-the-economy.html>

Smith College:

<http://www.smith.edu/controller/>

Seattle Pacific University:

<http://www.spu.edu/depts/parents/news/economy-Eaton-08.asp>

Critical Questions for College & University Presidents and Boards In a Volatile Economy

Immediate Matters

1. Has a current statement of financial projections—revised to reflect recent changes in revenues and expenses, including yield on endowment—been developed and reviewed by the appropriate board committee?
2. Has a current determination been made of whether there are any immediate liquidity needs that require action while longer-term analysis is undertaken?
3. Are any of the three “warning signs” of financial stress turning critical?
 - a. Declining enrollment
 - b. Declining net tuition per student or declining net tuition
 - c. Declining liquidity due to investment losses or operating deficit
4. Is it possible at this time to estimate with some degree of confidence the scope and likely, as well as potential, consequences of the economic and financial crisis for the next 15-18 months for the following?
 - a. The current operating budget
 - b. State funding for operating and capital budgets
 - c. Student financial aid
 - d. Tuition and fees for academic year 2009-10
 - e. Enrollment for spring term and next fall
 - f. Current hiring
 - g. Institutional debt/financing
 - h. Retirements of staff and/or faculty
 - i. Fund-raising and any anticipated comprehensive capital campaign
 - j. Endowment and endowment spending
 - k. Underway or planned capital projects
 - l. Matching or in-kind obligations for grants or gifts
5. Is it appropriate to consider changing the annual endowment spending rate in the near- or mid-term and, if so, with what consequences for the mid- and long-term?
6. What communications about the current crisis have taken place between the president and the board and between the president and institutional stakeholders (e.g., parents of students, alumni, staff)?
7. Has anyone either within the administration or on the board had significant experience working with an organization or a business undergoing severe financial hardship? Have such persons been asked for advice and counsel?

8. Have we determined whether financial aid is sufficiently available for currently enrolled as well as incoming students? What alternatives, including short-term loans, are being considered?
8. Do the board and administration have a financial exigency plan? Is that plan tied to the institution's strategic plan? Does the exigency plan provide for "staged" action according to the severity of the financial situation?

Looking Beyond the Immediate Challenges

1. How does the current upheaval compare with difficult economic times of the recent past, e.g., 2000? What actions did the board and administration undertake in previous recessions? What were the effects of those actions?
2. What are the likely consequences of a prolonged recession for your institution over the period 2010-2012 (see the items listed above)?
3. What current priorities can be distinguished from those initiatives that can be delayed?
4. Does the institution's strategic plan call for significant additions in degree programs, research, public service or facilities? Have the costs of these additions been factored into current financial expectations of the institution? Can/should any of these initiatives be delayed?
5. Does the college or university participate in inter-institutional collaborations such as coordinated library acquisitions, volume purchasing, joint enrollment in low-enrollment programs/courses, shared technologies and technology infrastructure? If not, can such opportunities be explored with other institutions?

Preparing to Turn Things Around

1. When economics and finances improve, which assets of the institution do the president and the board believe must emerge strengthened?
2. Do we need to consider taking on somewhat greater exposure to risk in order to regain lost principal and dividends in out years? If so, how much risk are we prepared to accept?
3. If the current recession extends beyond 2009 and well into 2010, what planning should the president and board be undertaking now to engage the larger campus community in more significant institutional change?