

The Internal Bank: Managing the Debt Portfolio

By Chris Cowen, Jon Speare and Linda Fan

Commonfund's paper, "The Internal Bank: The Next Opportunity in Operating and Non-Endowment Assets," described forward-thinking nonprofit organizations that structure their traditional treasury operations as an independent, consolidated service provider—as an "Internal Bank." That paper focused on the management of an institution's working capital and other liquid operating (non-endowment) assets. This paper, the second on the Internal Bank concept, examines the liability side of the balance sheet. By actively and strategically managing its debt capital, with a careful eye on its operating assets, and integrating both asset and liability management through strategic resource planning, public and private nonprofit organizations can increase their ability to maximize their net assets in support of their mission.

This paper is the result of a collective effort by Commonfund, Prager, Sealy & Co., LLC and The Working Group on the Internal Bank (see Appendix V).

Debt in the Capital Structure—Policy and Practice

Historically, nonprofit organizations, especially educational institutions, have been conservative in the amount of and way they issue debt. Until the early 1980s only a few institutions used debt to finance their facilities and, generally, those debt financings were limited to revenue producing projects such as housing complexes, parking garages and utility plants. Over the past 25 years, debt has become an integral component of the capital structure of many nonprofit institutions and today is used to finance a wide range of facilities and, in a number of instances, working capital requirements.

Although debt is not a panacea without risk, incorporating debt into the capital structure of a nonprofit offers a number of advantages.

- Debt allows institutions to plan and execute major capital programs on a systematic basis by providing a financing mechanism that spreads cash flows over longer periods of time.
- Debt allows institutions to plan and manage major capital projects without having to directly coordinate cash flows from gifts or other funding sources with individual projects.
- Debt imposes the financial discipline of building debt service requirements into the operating budget so that, over time, debt capital becomes a permanent financing source for future projects.
- Debt can provide access to a "low cost" source of funding.
- Debt allows unrestricted and quasi-endowment funds to be invested on a basis consistent with the institution's long-term investment horizon.

According to our Commonfund Benchmarks Studies, many Trustees and financial officers have tended to plan and manage debt on a “bottom-up” basis: debt decisions have been driven by specific projects at specific moments in time. This is due, in large measure, to the significant role that external parties (see Appendix I) historically have played. Bond indentures and commercial bank loans often contain restrictive covenants and other requirements regarding the debt (e.g., accelerated principal amortization schedules, overly restrictive allowable uses of proceeds, leverage and operating covenants, etc.) and rating agency guidance has commonly sought to define debt capacity and identify the allowable amount of variable rate debt or “acceptable” exposure to derivative products. Finally, there has been a direct linkage of bond or loan proceeds to specific projects to comply with tax requirements as well as to simplify operating and capital budget accounting.

Our position is that debt:

- 1) should be viewed as a permanent component of the organization’s financial structure, and is an important source of capital for its Internal Bank;
- 2) should be managed in a portfolio approach; and
- 3) should have a well-thought-out policy that is developed with a long-term approach.

As a result, an institution’s debt portfolio is often a compilation of independent funding decisions rather than the product of carefully managed, long-term financial strategies. More often than not, this limits the ability of an institution to take advantage of market opportunities which, in turn, leads to sub-optimal debt structures and a lack of integration of the debt portfolio with long-term capital planning. We believe that debt should be viewed as a permanent component of an institution’s financial structure, and an important source of capital for its Internal Bank. An institution’s debt holdings should be managed using a portfolio approach and policy that in some ways parallel methodologies utilized in managing assets at the institution.

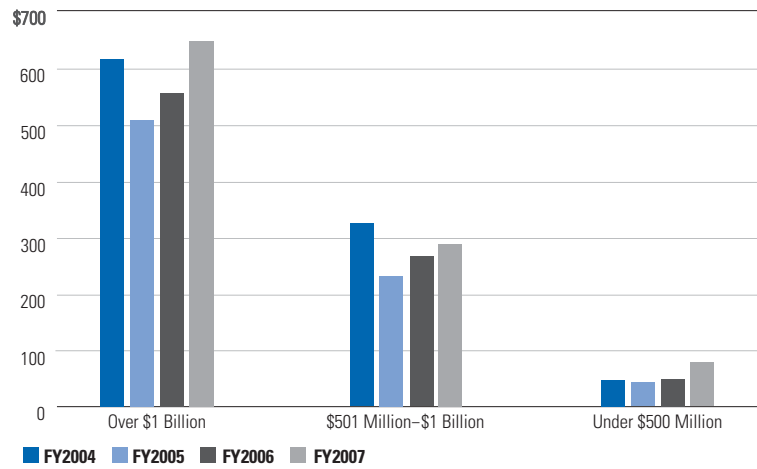
Nonetheless, as shown in Exhibits I and II, nonprofit educational institutions have been differentiated in the amount of debt in their capital structure. Larger universities tend to utilize debt more than smaller schools; and, looking ahead, 52 percent of very large universities are planning to increase present debt levels over the next two fiscal years. Smaller institutions are taking a more conservative approach to debt issuance with only 28 percent planning to increase their debt levels.

EXHIBIT I

Average Total Debt (of Institutions with Debt)

FY2004–FY2007

Dollars (\$) in Millions



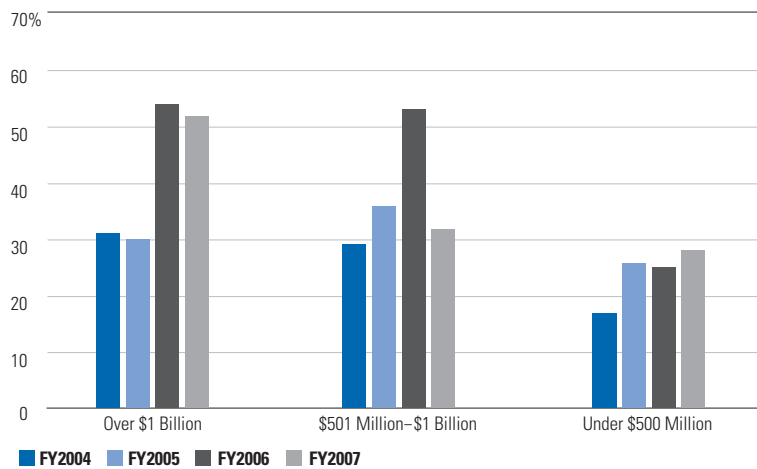
Source: Commonfund Benchmarks Study *Educational Endowment Reports* 2005 through 2008

EXHIBIT II

Plan to Increase Debt in Next One to Two Fiscal Years

FY2004–FY2007

Numbers in Percent (%)



Source: Commonfund Benchmarks Study *Educational Endowment Reports* 2005 through 2008

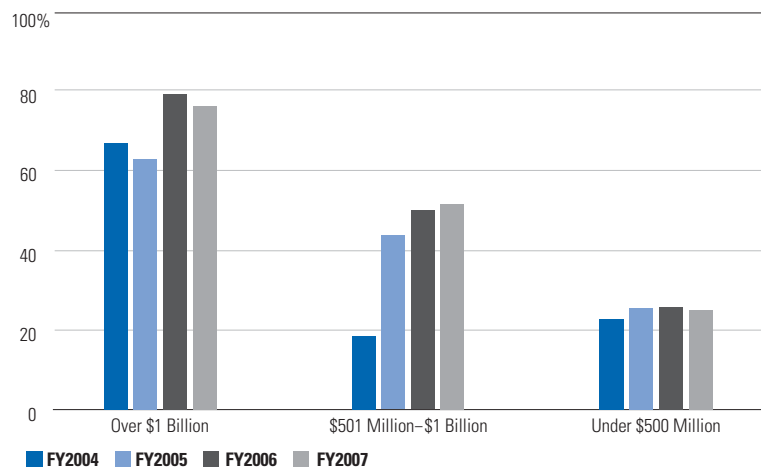
Despite the increasing use of debt by educational institutions, less than 30 percent have a formal debt or liability management policy governing its use. In Exhibit III below, a higher percentage of the larger-endowed institutions have formal policies but as a whole, the majority of schools, particularly the smaller ones, do not. At its most basic, a debt policy helps the institution answer the question: How leveraged are we, and are we *appropriately* leveraged? Debt policies generally address a number of issues: Given our assets and operations, what is our debt capacity and what are the appropriate measures that will keep us from becoming over- or under-leveraged? Should debt capital be restricted to certain purposes? Should we issue fixed rate debt, variable rate or a combination of both? How should we plan and fund annual debt service? What risk level is the institution willing to take while issuing debt, and deciding on debt portfolio structure? What processes should be in place to plan and manage the use of debt, be it internally or externally funded, and how do we ensure that the use and management of debt is fully integrated with our asset management, as well as our operating/capital budgeting and strategic planning? Appendix II is a sample of Debt Policy Guidelines.

EXHIBIT III

Has a Formal Debt Policy (Percent of Institutions Familiar with Debt)

FY2004–FY2007

Numbers in Percent (%)



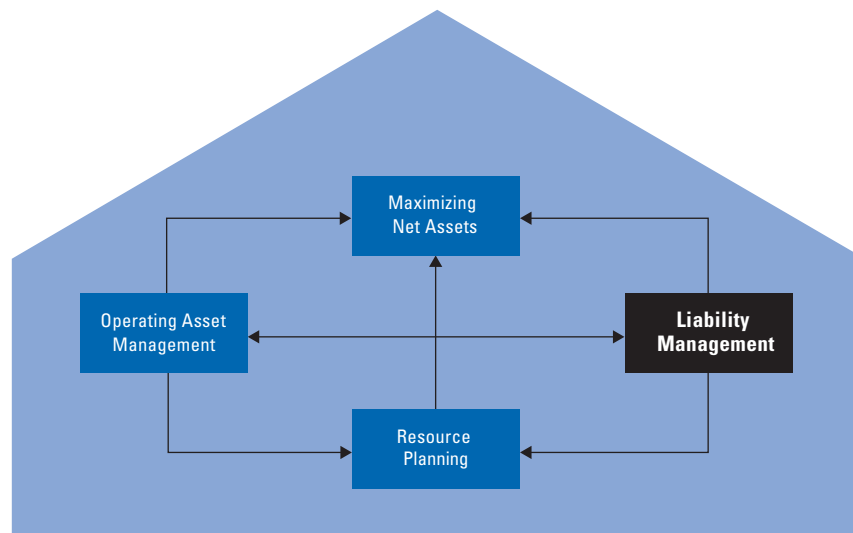
Source: Commonfund Benchmarks Study *Educational Endowment Reports* 2005 through 2008

The Internal Bank

Nonprofit organizations have continued to develop more effective, strategic and efficient treasury operations—managing some resources as a deposit base, investing significant liquidity assets, utilizing sophisticated liability management tools and serving as an efficient transaction processor—in short, treating their financial operations as an “Internal Bank.” This represents an important transformation for nonprofit organizations and creates new opportunities for these institutions to maximize their net operating resources.

Just as there is no single endowment policy portfolio that fits all institutions, there is no single preferred debt policy that will fit each institution. Moreover, the use of debt seems to follow an evolutionary process requiring periodic changes to governance, planning and financial management structures. Some institutions have expanded their liability management policies to better manage their debt as a portfolio—be it internally or externally funded, fixed or floating, long-term or short—and to allow for expanded purposes such as for traditional project financing as well as for non-project-specific, operating cash optimization or liquidity management. Increasingly, the more sophisticated institutions are marrying these policies with the concept of the Internal Bank—a way of describing the centralized operating unit that provides comprehensive, cross-functional and active management of the debt portfolio, linking the sourcing of funds with the use of funds and integrating both with overall balance sheet management, and allowing greater transparency for governance and compliance purposes.

FIGURE 1
Integrated Treasury Operations—“An Internal Bank”



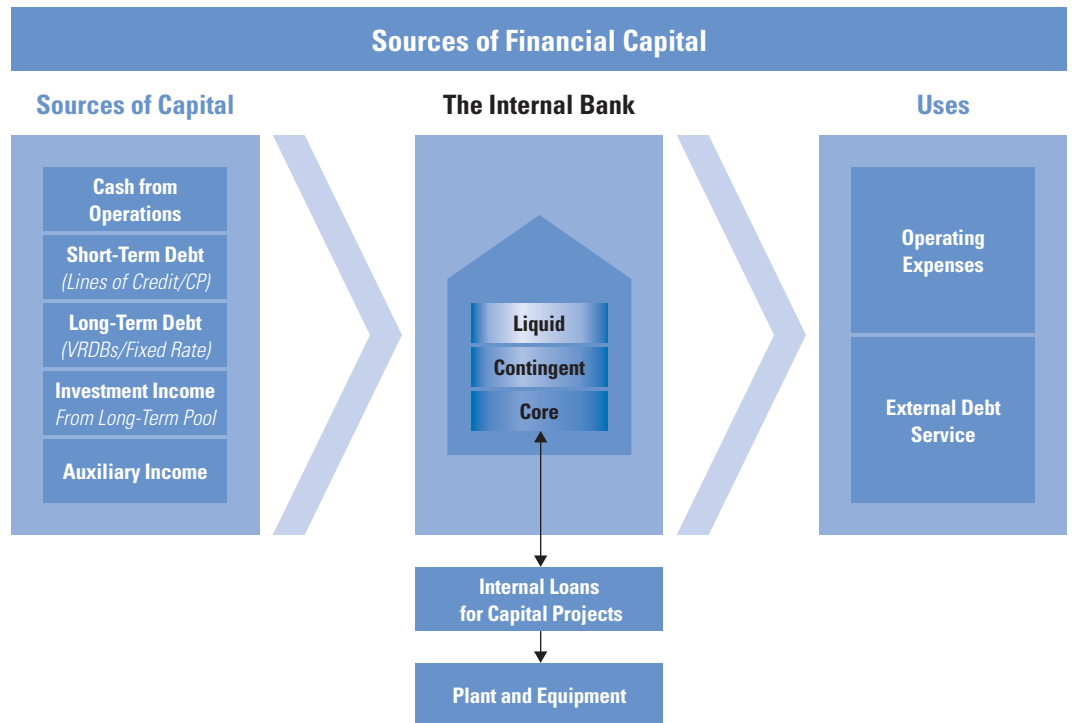
An important strategic goal for the Internal Bank is to combine all historically independent treasury and financial management “silos” into one business view. This organizational approach not only permits greater opportunities for generating the resources to benefit the entire organization, it also facilitates enhanced financial management of the organization.

The Internal Bank concept allows an institution to examine the costs of all its available sources of financial capital, including opportunity costs,¹ and use those sources with the lowest expected long-term cost. These sources can include internal sources of funding such as cash and retained reserves as well as external sources, primarily debt and philanthropy. For each institution, the relative cost of each source will differ and may change over time (e.g., as an institution is or becomes more leveraged, external funds may become more expensive or restrictive, thereby causing it to favor other funding sources). Additionally, the institution's current and projected interest and reinvestment rate assumptions, future initiatives, and risk tolerances will factor into the relative and expected cost of funds (which is why no two institutions will target the same level of leverage or debt portfolio structure). The Internal Bank attempts to exploit the circle: by consistently using the least expensive source of capital, resources are maximized; maximizing resources leads to a stronger balance sheet; a stronger balance sheet improves the institution's credit rating; a higher rating improves access to the credit markets and often results in a lower cost of funds—which maximizes resources and so on and so on.

Figure II illustrates capital sources and a bank's ability to take advantage of different capital costs. The Internal Bank's working capital rises through additions of net revenues and debt proceeds, while it is depleted through daily and capital expenditures. The holdings are operating assets that can be appropriately invested. Although most of these assets are not perpetual, or endowment-like, they provide an opportunity for the institution to generate additional resources, as documented in our first Internal Bank paper. Over time, the institution has the ability to benefit from borrowing at a lower cost rather than depleting operating assets which can be managed based on time horizons. An organization should always be cognizant of its cost of funds and holding of funds. The diagram shows indicative rates from fiscal year 2007 where a "AAA" organization could borrow funds at rates between 3.8 percent and 5.7 percent (dependent on type and maturity of borrowing) and invest assets at investment returns of between 4.8 percent and 16.9 percent (dependent on the time horizon of holding those funds). Organizations need to remember that it is critical for the Internal Bank to always have liquidity for daily expenses, and accessible limited term assets for unexpected needs. However, as emphasized in the last paper, excess liquidity can be expensive and should be better managed.

¹ For example, using working capital to fund projects may appear less costly compared to the return on operating cash. However, if an institution has excess working capital to spend on projects, then it is likely that such excess liquidity could instead be available for re-allocation to higher returning, longer duration investments, thereby increasing the opportunity cost of using such funds for project costs.

FIGURE II



Average Rates¹

For the Year Ended June 30, 2007

Sources of Financial Capital	Aaa/AAA Institutions	Aa/AA Institutions	A/A Institutions	Baa/BBB Institutions
Lines of Credit	5.4%	5.4%	5.5%	5.62%
Tax-Exempt Debt				
CP/VRDBs	3.8%	3.8%	3.9%	3.9%
Fixed Rate Bonds	4.7%	4.7%	4.7%	4.8%
Taxable Debt				
CP	5.4%	5.5%	5.6%	5.6%
Fixed Rate Bonds	5.7%	5.8%	6.0%	6.3%

Note: Included estimated cost of liquidity if required

Source: Prager, Sealy & Co., LLC

Indicative Financial Capital Returns¹

For the Year Ended June 30, 2007

Liquid	4.8%
Hypothetical Limited-term Portfolio	6.2%
Endowment	16.9%

Liquid—3-Month Treasury Bill Yield

Hypothetical Limited-Term Portfolio—30% Merrill Lynch 1-3 Year Treasury Index, 30% Lehman Aggregate Bond Index, 40% 3-Month Treasury Bill + 200 Basis Points. The return is based on the historical performance of the constituent indices for a hypothetical portfolio and is not an investment recommendation of Commonfund. See Important Legal Disclosure, *Hypothetical Asset Allocation*, on page 23.

Endowment—Commonfund Benchmarks Study *Educational Endowment Report 2008*, average annual total return for 767 institutions.

Of course, performance cannot be guaranteed, and past performance may not be indicative of future results.

¹ As we have seen, rates can change quickly and dramatically; however the long-term strategies and conclusions remain consistent.

The Internal Bank is a “top-down” approach to managing capital. Funding decisions are made with the goal of prudently accessing the lowest cost of capital available. Although rates on the liability and the asset sides may be volatile, over time, the organization will be able to generate resources through lower debt capital costs and operating asset investment returns. Therefore by acting like a bank, the organization can act to produce positive net interest margins that generate additional resources over time.

Managing the operating financial assets and debt portfolio of the organization, the Internal Bank can be a major factor enabling the organization to achieve its long-term mission. But it begs the question: What part of the organization manages the Bank—who has responsibility for its operations—and to whom is the “Internal Bank” accountable? To foster the independent business management of the Bank, some have found it useful to account for their Internal Bank as a separate unit (see Appendix III for a sample hypothetical report), independent from the organization’s overall financial statements, but usually reporting to the chief financial officer and/or treasurer.

Institutions have developed formalized governance for the management of their long-term endowment assets with the ultimate formal governance most often assigned to an investment committee of the board. The same should be for the Internal Bank—with a finance committee taking the lead in focusing on the overall financial and capital structure of their institution and integrating with overall resource planning for the entire organization. The areas that the governing committee should address include:

- All facets of debt policy liquidity management guidelines
- Operating asset management policies (cash, limited-term, long-term non-endowment financial assets)
- Overall strategic goals for the Internal Bank
- Accountability measures and reporting requirements
- Compliance procedures

Constructing and Managing the Debt Portfolio

An active approach to constructing an optimal external debt portfolio includes many components: evaluating overall interest rate and tax risk (risk management), incorporating the institution's working capital and liquidity needs (debt/liquidity management), the fixed/variable allocation, and duration management. Similarly, the institution must develop guidelines related to the internal management of debt, including internal loan provisions, an institutional blended rate charged internally for debt service and other expenses, guidelines for sourcing capital, and procedures for compliance. While tax and compliance regulations clearly impose certain considerations and ongoing challenges to managing the debt portfolio, these are not insurmountable and should not dictate an institution's strategic choices.

While the largest and wealthiest institutions have greater flexibility in removing external financial controls over their transactions and managing their debt capital as a portfolio, smaller, less-endowed institutions with weaker credit can reduce third-party limitations by adopting a portfolio approach to debt management that is:

- driven by institutional priorities;
- focused on preserving flexibility and minimizing cost within acceptable risk parameters over the long term;
- consistent with budgeting (capital and operating) and investment (cash, limited term, and endowment) management procedures;
- minimally burdensome administratively; and
- in compliance with all requirements and policies.

A sample of large institutions is shown in Exhibit IV. Each university manages their debt capital, as well as the levels of liquidity on hand, in a portfolio approach. Each has unique goals and objectives to which they manage their portfolio.

EXHIBIT IV**Examples of Debt Portfolios***Public Universities*

Dollars (\$) in millions	Institution 1	Institution 2	Institution 3	Institution 4	Institution 5	Institution 6	Institution 7
Investments: Endowment	\$678	\$2,338	\$1,621	\$1,600	\$3,898	\$357	\$1,700
Liquidity (Cash)	\$477	\$708	\$316	\$765	\$760	\$23	\$224
Debt	\$626	\$1,118	\$667	\$872	\$551	\$354	\$1,000
Fixed/Variable Mix* in percent (%)	84/16	57/43	75/25	75/25	80/20	100/0	100/0
Blended Rate in percent (%)	N/A	4.30	N/A	5.03	4.75	N/A	Provisional 5.5

Private Universities

Dollars (\$) in millions	Institution 1	Institution 2	Institution 3	Institution 4	Institution 5	Institution 6
Investments: Endowment	\$7,244	\$6,590	\$6,226	\$29,219	\$5,975	\$3,488
Liquidity (Cash)	\$405	\$152	\$142	\$100	\$345	\$692
Debt	\$1,212	\$941	\$1,397	\$3,135	\$595	\$1,105
Fixed/Variable Mix* in percent (%)	89/11	80/20	66/34	82/18	61/39	45/55
Blended Rate in percent (%)	5.17	5.5	4.40	5.50	N/A	4.40

*Fixed/Variable mix reflects interest rate swaps

Note: Each member of the Working Group on the Internal Bank (Appendix V) provided data used in Exhibit IV.

Risk Management

By treating all external (e.g., debt, loans, lines of credit, philanthropy) and internal (e.g., accumulated reserves and operating cash) sources of capital as a portfolio to be managed strategically, market exposures such as interest rate risk can be better managed. For example, variable rate debt costs that rise in a high rate environment can be offset by increasing operating cash returns and vice versa in a low rate environment. Since the offset in the earnings and costs may accrue to different departments or uses for different parts of the institution, it would be simplistic to view the two pools as a perfect hedge; however, the risk can be pooled and, therefore, managed more effectively for the benefit of both the debt portfolio and the operating budget. Some institutions have established a single institutional reserve account, or interest rate buffer, rather than one for the debt portfolio and a separate one for the operating funds. This reserve is similar in concept to a commercial bank's capital reserve that is in place for both sides of the financial institution's balance sheet.

An important consideration while constructing the debt portfolio is being mindful of downside risks. As noted earlier, debt is not a panacea, or without risk. Volatile interest rates and higher debt costs can create a negative interest margin against assets invested. Periods of financial stress often result in widening credit spreads and can have adverse consequences for auction based offerings. A steep increase in volatility or decrease in market liquidity can impede otherwise efficient debt issuance markets. In these environments, variable rate offerings become expensive and periodic auction offerings may produce undesirable results. In the worst times, debt funding may altogether be unavailable. Although these periods are exceptional, they are a reminder of the negative risks within the capital markets, and need to be incorporated in debt portfolio modeling and while constructing policy guidelines. Overall, institutions need to be flexible in their sourcing of funds with a long-term horizon in order to weather these exceptional periods.

There are a number of tools available to help manage the debt portfolio through most environments. For example, there are asset/liability management programs, sophisticated financial models enabling better analysis, and other tools to analyze and quantify risk such as Monte Carlo simulations that are often used to “stress test” the use of debt or the impact of interest rate moves. Additionally, information technology systems have evolved to provide more and better information about an institution’s finances and cash management needs. The use of sophisticated modeling is not only useful in understanding capacity, but also tests volatile and “financially stressed” periods. This allows management to project downside possibilities of the debt portfolio and make prudent decisions on structure and characteristics of the portfolio.

Debt/Liquidity Management

As an institution pools its sources of funds, any funds not used to finance projects will add to liquidity.² As we showed in our first paper on the Internal Bank, we believe that most institutions maintain excess liquidity. Since that paper, some institutions that operate Internal Banks have been putting excess liquidity to work in order to generate additional resources. Similarly, the portfolio approach to liability management can result in the accumulation of additional liquidity, compounding the need to develop effective operating asset management practices. The institution should determine its desired liquidity position consistent with its risk tolerance—consistent with its desired “liquidity risk.” For example, institutions with more precise cash forecasting abilities may feel comfortable with lower levels of liquidity. Institutions with stronger credits may have a greater ability to acquire low cost external sources of liquidity (unexpended debt proceeds) and be less vulnerable to widening spreads and resulting liquidity gaps in the market. In any case, an investment policy that actively manages operating assets should be established in order to maximize return and maximize net assets. Our first paper expanded upon the concept of timeframe arbitrage and diversification within operating portfolios to accomplish this objective.

² Generally, this will be when the long-term cost of external capital is lower than the expected cost of internal funds.

Fixed/Variable Allocation

The concept of fixed/variable allocation in the debt portfolio increasingly is an oversimplification of a liability management challenge. The first problem is definitional—what constitutes variable rate debt?

Generally, notes, commercial paper and variable rate demand bonds (“VRDBs”) are considered variable, along with auction rate notes (“ARNs”). In addition, debt to be issued in the future—even if expected to be a 30-year fixed rate issue—is variable until it is issued, and medium-term notes and term puts, while having longer duration than short-term debt, impose an added degree of variability on the debt portfolio.

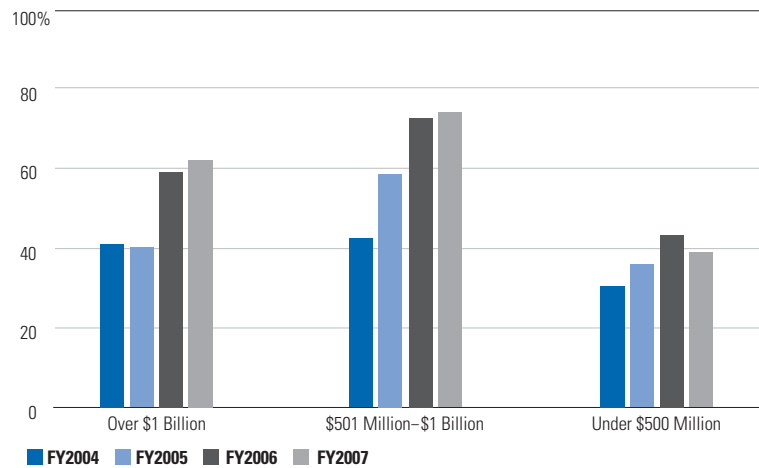
The second problem is isolating the interest rate component of risk from other components of risk, particularly in a tax-exempt issue. The fixed/variable decision is generally thought of as interest rate risk evaluation. However, the rates used are rarely directly comparable from a risk standpoint. There are some key risks associated with tax-exempt variable rate debt that are not present in long-term tax-exempt fixed rate debt. As a result of the proliferation of derivative products in the marketplace, interest rate risk can be isolated from the other risks, such as tax risk and liquidity risk, in order to achieve a more direct measurement of interest rate duration. Appendix IV highlights that the compilation of the overall interest rate paid by the institution is due to numerous underlying market factors. The overall rate can be adjusted by removing interest rate risk (issuing long-term fixed rate bonds or utilizing a floating-to-fixed swap), removing general tax risk (issuing fixed rate bonds, utilizing a tax-exempt index based swap, or executing a reverse basis swap) and by the cost of an economic call option. The cost to assume or remove these risks changes based on the transaction structure as well as the market. For a dynamic and actively managed portfolio, we recommend that the institution assume risks when the cost of removing them is high, and remove risks when the cost is low, provided that the total exposure does not exceed risk tolerance levels as indicated in the debt policy.

EXHIBIT V

Use Interest Rate Swaps to Manage Exposure (Percent of Institutions with Debt)

FY2004–FY2007

Numbers in Percent (%)



Source: Commonfund Benchmarks Study *Educational Endowment Reports* 2005 through 2008

The issue of fixed/variable allocation is fundamentally one of portfolio duration. On the asset side, investors typically seek opportunities to extend duration to capitalize on the risk premium embedded in the yield curve or to exploit timeframe arbitrage. We believe that, to the extent an investor can justify a longer investment time horizon, they will be able to incur greater risk and improve their return potential. Active management, of course, may add value when investors correctly perceive that risk premiums or implied forward interest rates are mispriced.

The concept on the liability side is nearly identical, except instead of risk/return optimization, the goal is risk/cost optimization. A crucial difference, however, is the turnover of the two portfolios. To minimize cost, a borrower would seek opportunities to limit duration of the debt portfolio and avoid paying the risk premium. On the asset side, bonds (especially long-term bonds) are, for the most part, not held to maturity—they are traded. The same, to some extent, is true on the debt side. The vast majority of tax-exempt bond issues are refunded prior to maturity. However, comparing the asset side and the debt side, existing fixed income assets are more likely to be sold at a gain or loss prior to maturity, or potentially shifted to a different asset class. This means that although the debt portfolio positioning and the asset portfolio positioning have similar impacts on the risk and cost of capital to the institution, the asset portfolio has more flexibility to be repositioned. But, by managing the debt as a portfolio, the institution recognizes there is the ability to reposition the portfolio through issuance and derivative management, including swaps. This effectively gives the institution the financial tools on both sides of the balance sheet to manage cost of capital and portfolio risks. Although the institution should actively manage its debt portfolio, it is critical that it be structured for long-term objectives and not have the appearance of a speculative portfolio, which most institutions specifically prohibit.

Definition of Blended Rate

The blended rate represents an institution's long-term expected "expense" of its external debt portfolio expressed as an interest rate. This rate often includes "buffers" to protect against interest rate risk or tax risk associated with any variable rate bonds and/or interest rate swaps in the debt portfolio. In addition, ongoing costs related to the management of the debt portfolio (rating agency, trustee fees, state/local authority fees) may also be included. Some institutions include all costs associated with their Internal Bank, including staff compensation. Many recalculate this rate annually and reevaluate interest rate and tax rate assumptions, as well as any changes to its debt portfolio. Some reset the rate so the Internal Bank will break even each year and will re-set the new rate based on actual performance; others desire to manage the rate so that it does not change much from year to year.

The Blended Rate

As indicated in an institution's investment policy, asset pools are managed to generate the highest expected long-term total return consistent with the institution's risk profile and time horizon of the assets. It is reasonable that a similar approach to liability management would be most beneficial to the institution. In other words, external capital (debt) and internal capital (cash, limited-term and longer duration assets) should be pooled and managed regardless of source in order to achieve the lowest long-term portfolio cost consistent with the institution's risk profile (as indicated by its debt policy and views toward leverage, variable rate debt, derivatives, etc.). When capital is viewed in this way—independent of the source and as a pool with a blended portfolio cost of capital—it is necessary to establish a process and cost for originating "internal" loans, e.g., loans to projects, departments, divisions, etc., and providing funding. In other words, the Internal Bank should establish consistent lending strategies and procedures and create a single cost of funds that takes into account its own average cost of capital. By using a blended rate that reflects the institution's overall cost of capital, an institution can allocate its funding costs uniformly across all units and make financing decisions independent of a specific project or economic conditions.

When capital is managed as a portfolio, additional debt is generally issued during different interest rate periods creating a diversified debt portfolio. In a mature program, the impact of individual bond offerings and the cost of actively managed "deposits" on the blended rate should be marginal over time. As a result, the blended rate ideally provides a smoothing effect for capital costs, similar to the way institutional spending policies reflect investment portfolio returns over a number of years. Indeed, the concept of maintaining "intergenerational equity" in the endowment is consistent with the use of debt funding for capital projects and budgeting debt service using a blended rate approach; future generations pay for capital projects, over time, based on the institution's overall cost of capital, rather than costs being driven by specific capital market conditions which may coincide with the timing of such project.

As seen in Exhibit IV, our institutions surveyed had blended rates currently ranging from 4.3 percent to 5.5 percent. The rate charged to different units/departments will reflect not only the direct cost of capital, but also ongoing costs of managing the capital portfolio and, in many cases, a "buffer" for any variable rate debt to protect against possible increases. A blended rate allows the institution to manage its capital on a portfolio basis, rather than as a series of debt transactions, lowers overall cost and acts as a "smoothing" agent to volatility in the capital markets. The blended rate allows the institution to manage risk, as well as costs, by spreading both over different generations of programs and projects.

Conclusion

The concept of the Internal Bank and its components is evolving in nonprofit organizations. Those that continually seek to manage their balance sheet, capital structure, operating assets, liquidity and debt in a top down approach (or a bank) are better equipped to maximize resources and meet their objectives. Each organization deploying an Internal Bank approach needs to identify its unique goals and then develop their bank to reflect these goals. The adage, “If you have seen one Internal Bank, you have seen one Internal Bank,” reinforces the mandate that there is no one model that fits all Internal Banks. Successful banks are the outcome of an organization’s governance and management developing clear goals for that organization. These goals can include:

- Maximizing net interest margin
- Managing downside risk
- Enhancing capital project planning
- Organizational resource planning
- Breaking down department “silos”
- Transparency and fairness in internal lending
- Better cash flow management
- Creating long-term unrestricted resources
- Better prioritization of capital projects
- Lowering cost of capital for the organization
- Risk management through possible economic environments
- Protecting future projects from capital market uncertainties

By addressing capital structure and the use of debt as part of an overall strategy for managing the entire financial operations as an Internal Bank, an organization can better manage the full spectrum of financial capital and can strengthen its financial position in order to better serve its mission. Although all capital (human, physical and financial) is equally important to the success of an organization, better utilization and strategic management of financial capital through the Internal Bank will add to the resources and the stability of those entities that we are committed to serve.

Appendix I

External Relationships: Bond Authorities, Rating Agencies and Investment Banks

Bond Authorities

In most states, the issuance of the tax-exempt debt by educational institutions is controlled through a state bond authority. All bond issuances must be reviewed and approved by the authority. These authorities work with institutions to review financing plans, project eligibility and bond structures, and to schedule and price bond offerings. Each authority works with institutions in different ways. Forming excellent working relationships with these authorities is important. The state authorities also offer pooled financing programs that may prove to be a cost-effective financing alternative to your institution.

Rating Agencies

While bond ratings are not always required, most institutions find it useful to have their debt issues rated by one or more of the national rating agencies. A rated offering widens the market for the bonds. The rating process should be viewed as an opportunity to present and discuss openly the institution's plans in a comprehensive manner. Rating agencies evaluate both quantitative and qualitative aspects of the institution.

Clearly, the finances of the institution matter. A strong balance sheet and stable operating results are very important. In addition, the rating agencies will want to discuss and review the institution's student application and enrollment statistics and trends, as tuition often represents the majority of the institution's revenues. The rating agencies will want to understand the institution's fund-raising plans and recent giving trends. They will want to understand the institution's governance and management structures. Presentations to rating agencies are not a one-time event. They are part of an ongoing relationship and communication process with rating agencies.

Institutions often have relied on the bond rating (e.g., an institution does not want to risk losing its current ratings and will manage its leverage accordingly) as an indication of debt capacity. However, the role of ratings as a driver of leverage is often misplaced, since ratings should not determine the institution's funding priorities—e.g., few would argue that a project should advance solely because it can be debt financed and the incremental debt would not impair the rating. Moreover, in recent years, there has not been a significant difference in the cost of capital associated with a one- or even two-notch rating downgrade. Ideally, the credit rating should represent an ex-post evaluation of the institution's funding process and decisions as well as other quantitative and qualitative factors and is an input to determining debt capacity—not a driver.

Investment Banks

Bond issues are usually sold through a negotiated deal with an investment banking firm that underwrites the bond issue and sells it through its public finance desks, often in concert with one or more investment banking firms. The bond authority and the financial adviser to the authority generally play a key role in selecting and managing the investment bank syndicate.

Appendix II

Debt Policy Guidelines

A debt or liability management policy should reflect the institution's unique needs and strategic objectives, there is no one model debt policy that fits all institutions. In fact, the process of developing and customizing the policy to the institution is critical. However, in developing a debt policy, the following guidelines should be considered:

- Articulate the institution's philosophy about debt that governs all commitments of the institution. This should explain why the debt policy is being created, how it will be used to govern the incurrence of debt to achieve strategic objectives and for what purposes deviations are acceptable. It provides criteria for management and the governing board to interpret the other components of the policy. The institution may wish to explicitly acknowledge that the policy is consistent with state law and guidelines and legal and tax requirements.
- Select the limited number of key ratios and establish specific financial ranges for the appropriate financial boundaries of the institution's operations. Generally, no more than two to four ratios are used to represent the overall health of the institution and to keep the evaluation at a high, strategic level (other ratios could be tracked as well for management purposes). Typically, the Viability Ratio and Debt Service Burden Ratio would be two of the ratios monitored.
- Develop a policy and procedure for the prioritization and monitoring of capital projects with input at the applicable operating level (e.g., school, department) of the institution. Guidelines should be broad enough to allow management flexibility; however, the policy should give priority to projects that are mission-critical and/or have a related revenue stream for repayment.
- Consider the desired mix of variable and fixed debt as well as permissible (or prohibited) debt structures and covenants. Targets should be established for fixed and variable rate debt percentages. When determining the appropriate variable rate allocation, the institution's cash and fixed income holdings should be considered.

-
- Contemplate the use of derivative products and establish guidelines regarding their evaluation and applicability. Increasingly, institutions have been developing a policy specifically geared to derivatives. A derivatives policy should complement or form a part of the debt policy.
 - State that the institution will interact with the rating agencies and analysts. The institution should not specify the attainment or maintenance of a specific rating as part of the policy.

Reference: Adapted from "Strategic Financial Analysis in Higher Education," 6th ed., © Bearing Point, Prager, Sealy & Co., LLC, and KPMG.

Appendix III

Internal Bank Financial Reporting

The sample statement of net assets and income statement below are an example of accounting for, and reporting on, an Internal Bank. In our example, at June 30, 2007, the Bank is responsible for total assets of over \$529.877 million with associated total liabilities of \$398.100 million. In fiscal year 2007, this structure was responsible for \$31.283 million of generated revenues including investment returns (both the operating asset portfolio and the operating assets invested in the endowment) and the incoming debt payments from all internal loans made by the Treasury operation. At June 30, 2007, this Internal Bank has an operating asset portfolio of \$149.868 million and outstanding loans internal to university operating departments of \$370.000 million. The associated expenses to these holdings are external debt payments on the \$365.000 million debt portfolio and a budgeted interest paid to the organization's operating budget. The budgeted interest paid to operating departments is based on a 3-month T-Bill return (estimated at 5 percent) on the whole operating asset portfolio; therefore, \$6.615 million was budgeted by the organization and shown as a transfer. After total FY2007 expenses (\$23.305 million), \$7.978 million is generated which is an increase in net assets for the Bank. This additional (and unbudgeted) resource can be used for unfunded needs of the organization's overall budget or for unrestricted reserves.

Hypothetical Statement of Net Assets³

Dollars (\$) in thousands	6/30/06	6/30/07
Cash and cash equivalents	\$ 51,000	\$ 44,868
Limited term investments	75,000	80,000
Operating assets in LT pool	20,000	25,000
	\$146,000	\$149,868
Internal loans to departments	\$350,000	\$370,000
Prepaid expenses	4,500	5,000
Capital activities	4,400	5,009
Total Assets	\$504,900	\$529,877
Accounts payable and accruals	\$ 3,900	\$ 4,100
External bonds payable	344,000	365,000
Due to (from) operations	25,000	20,000
Deferred revenue	8,201	9,000
Total Liabilities	\$381,101	\$398,100
Net Assets	\$123,799	\$131,777

Hypothetical Statement of Net Revenues³

FY2007

Dollars (\$) in thousands	
Earnings on investments	\$13,433
Interest on internal loans	17,850
Total Revenues	\$31,283
Interest on external bonds	16,340
Debt related fees	100
Salaries and related (treasury operations)	250
Total Expenses	\$16,690
Transfers to (from) treasury operations	
Budgeted interest paid to operations— 3-month T-Bill	6,615
Increase (Decrease) in Assets	\$ 7,978

Generating \$7.978 million of excess *unrestricted* resources is an example of managing the capital markets effectively while taking advantage of investment opportunities as well as diversification of risk.

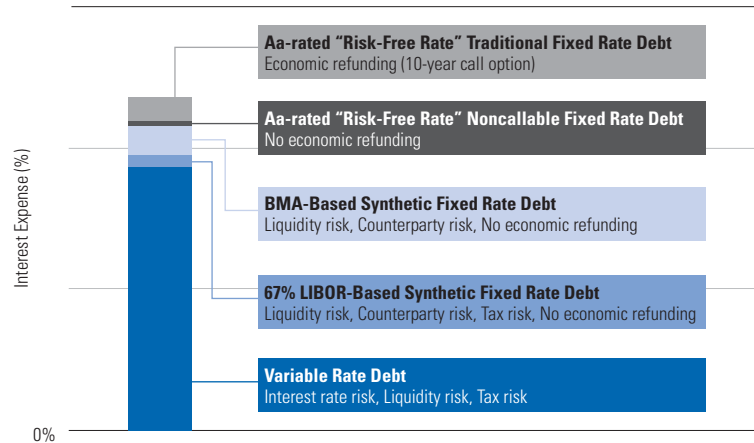
³ This is a hypothetical Statement of Net Assets and Statement of Net Revenues for an institution. The rates and returns utilized are consistent with rates previously sourced in Figure II (see page 7). Performance cannot be guaranteed and past performance may not be indicative of future results. See Important Legal Disclosure, *Hypothetical Asset Allocation*, on page 23.

Appendix IV

Constructing the Overall Portfolio

Rate and Risk Components

Rates as of June 30, 2007



Source: Prager, Sealy & Co., LLC

A traditional tax-exempt, long-term, fixed rate bond sells the following risks to the investor: tax risk, liquidity risk (unexpected),⁴ and typically the option of an economic refunding. Consequently, when comparing interest rate risk, the most appropriate rate is that associated with a percentage of LIBOR. Synthetic fixed rate debt with a LIBOR-based interest rate swap carries most of the same risks of traditional variable rate debt, so it is the most appropriate rate to evaluate against a short-term rate. Over the past three years, many schools have added interest rate swaps to cover a higher percentage of their debt portfolio. This increase is independent of the institution's size.

⁴ Although there is technically liquidity risk at maturity, given that it is an entirely predictable event, there is no potential for a *surprise* liquidity event.

Appendix V

The Working Group on The Internal Bank

Gail Hoffman	Treasurer	Columbia University
Roberta Edge	Associate Treasurer	
Victoria Nevois	AVP for Treasury	Duke University
Laura McAndrew	Senior Director, Treasury Operations	
Edith Murphree	VP for Finance	Emory University
Kim Pate	Director, Fiscal Planning & Management	
Craig McCurley	Director, Office of Treasury Management	Harvard University
Tom Balish	Treasury Operations Manager	
MaryFrances McCourt	Treasurer	Indiana University
Stewart Cobine	Managing Director & Assistant Treasurer	
Al Rodack	Associate Treasurer	The Ohio State University
Shirley DeJarnette	Treasurer	University of Missouri
Brian Smith	Director, Treasury & Risk Management	University of North Carolina
Pamela Arms	Associate Treasurer	University of Pennsylvania
Helen Kreider	Associate Treasurer	
Michael Gower	VP for Finance	University of Vermont
Yoke San Reynolds	VP for Finance & CFO	University of Virginia
Jim Matteo	Director of Treasury Operations	
Doug Breckel	CFO, Financial Management	University of Washington
Chris Malins	Senior Associate Treasurer	
Kevin Walker	Associate Controller	Vanderbilt University
Bret Perisho	Director of Finance (Medical Center)	

The authors want to thank and commend this working group on their leadership addressing the issues and opportunities within the “Internal Bank.” Over the past two years, this group has discussed and analyzed how different institutions manage their unique banks, and identified industry best practices. The above individuals gave their time and shared their expertise in order to benefit institutions working through Internal Bank challenges and opportunities.

Appendix VI

About the Authors

Chris Cowen, Managing Director

Chris Cowen is a Managing Director with Prager, Sealy & Co., LLC and heads its national higher education investment banking and consulting practice. He has 18 years of experience in the industry and is a registered securities principal. He has a bachelors degree from the University of Pennsylvania and an M.B.A. from the University of California, Berkeley.

Linda Fan, Managing Director

Linda Fan is a Managing Director in Prager, Sealy's higher education investment banking and consulting group. She has over 20 years of investment banking experience with higher education and not-for-profit clients and is a registered securities principal. Ms. Fan has an A.B. from Princeton University, an M.B.A. from the University of Chicago and an M.A.T. in mathematics education from Montclair State University.

Jon Speare, Managing Director, Co-Head Commonfund Strategic Treasury Solutions®

Jon Speare is Managing Director and Co-Head of Commonfund Strategic Treasury Solutions. In this capacity, Mr. Speare is responsible for the design and implementation of comprehensive treasury management programs for nonprofit organizations. Mr. Speare has over 20 years of experience in institutional financial services emphasizing investment and treasury management. He is a faculty member of NACUBO Professional Development and has written articles for Robert Morris Associates, NACUBO and the AFP Journal of Cash Management. Mr. Speare currently is a Co-Executive Director of the Treasury Institute for Higher Education and was a trustee of the Crozer Keystone Health System, as well as Finance Committee member of the Chester Community Improvement Project. He has a B.A. from Colorado College and an M.B.A. from Villanova University.

About the Prager, Sealy & Co., LLC

Prager, Sealy & Co., LLC is a national municipal broker/dealer with major offices in San Francisco, New York and Orlando. Since the firm was founded in 1987 with the assistance of two universities, higher education finance has remained a primary focus and strength of the firm. Prager provides comprehensive debt management services as either a financial adviser or underwriter to a range of private and public higher education clients throughout the country.

About Commonfund

Commonfund is the world's largest nonprofit investment manager. Our mission is to enhance the financial resources of nonprofit institutions and to help them improve investment management practices. Since 1971, we have focused exclusively on investment management for nonprofit institutions. Today, Commonfund serves more than 1,800 nonprofit institutions. We manage funds for more than 70 of the nation's top 100 educational endowments, as well as many of the country's largest foundations, operating charities and healthcare organizations. At the same time, a significant percentage of our clients have asset bases that begin at \$25 million. Our staff of about 200 includes experts in a wide range of asset classes, from fixed income to venture capital to hedge funds; we maintain leading-edge systems for reporting, oversight and risk management; and we advocate a strong client service culture. Our parent company is a nonprofit membership organization governed by a 12-member Board of Trustees, of whom 11 are outside trustees. The board is led by an independent, non-executive chair.

Important Legal Disclosure

Hypothetical Asset Allocation

Important Notes—Limited Term Asset Allocation Review

Returns for the scenarios assume a fixed allocation to each asset class that is rebalanced monthly, which may not necessarily depict the actual rebalancing process that likely would have taken place had an actual investor been managing these portfolios at the institution. These hypothetical scenarios do not represent the actual experience of any investor and do not represent recommendations of Commonfund Asset Management Company, Inc.

Quarterly and yearly calculations are based on rolling 3-month, 12-month and 36-month periods.

15 Old Danbury Road
P.O. Box 812
Wilton, CT 06897-0812

Tel 888-TCF-MAIN
Tel 203-563-5000
www.commonfund.org

commonfund

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