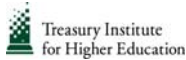


Rating Agency Panel Discussion

Josh Stern, Standard & Poor's: Higher Education Outlook

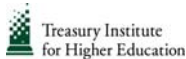
Pam Clayton, Fitch Ratings: Management, Governance, SOX

Susan Fitzgerald, Moody's Investors Service: Debt Structure and Derivatives



Higher Education Outlook

Josh Stern
Director
Standard & Poor's Ratings
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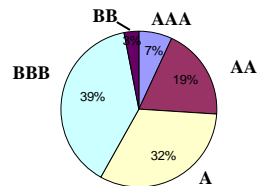


Higher Education Market Overview

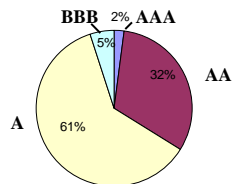
- ◆ Higher education now accounts for about 7% of the total municipal bond market, up from 6% in 2003 and 4% a decade earlier.
- ◆ Continuing a 2005 trend we expect to see debt issuance in 2006 that is spurred by “planned, regular issuance” and fewer refundings.
- ◆ Slightly less than 50% of the higher education bond market is insured; another 13% is backed by letters of credit; the balance is unenhanced. This is a relatively stable statistic.
- ◆ The amount of variable rate debt (demand bonds and auction rate) continues to grow. About 25% of issuance is now variable rate (5% auction rate and 20% variable rate demand bonds).
- ◆ More swaps are being done each year.

Overall Rating Distribution

Private Colleges and Universities



Public Colleges and Universities



College & University Rating Changes

- ◆ In 2000 and 2001 upgrades continued to greatly outnumber downgrades.
- ◆ Beginning in 2002 and continuing through 2004 downgrades slightly outnumbered upgrades.
- ◆ In 2005 upgrades exceeded downgrades for the first time since 2001.
- ◆ S&P expects this trend to continue into 2006.
- ◆ The fastest growing group of private college and university ratings are in the “BBB” category.
- ◆ Most high yield ratings never become public.
- ◆ S&P expects more public non-investment grade ratings as “BBB-” credits are downgraded.

Private College & University Rating Changes in 2005

Various 2005 Rating Changes

	<u>Action:</u>	<u>From:</u>	<u>To:</u>
▪ St. Ambrose University, IA	Upgrade	BBB	BBB+
▪ St. Edwards University, TX	Upgrade	BBB	BBB+
▪ University of Denver, CO	Upgrade	A-	A
▪ York College, PA	Upgrade	A-	A
▪ Bryant University, RI	Upgrade	A-	A
▪ Southern Methodist Univ, TX	Upgrade	A+	AA-
▪ Immaculata College, PA	Downgrade	BBB-	BB+
▪ Dowling College, NY	Downgrade	BBB-	BB+
▪ Babson College, MA	Downgrade	A-	BBB+
▪ Hendrix College, AR	Downgrade	A+	A

Public University Rating Changes in 2005

Rating activity is mixed for public universities. In 2005 there were three upgrades and two downgrades. 2006 is expected to remain mixed to trending positive.

- No real softening in demand despite large tuition increases;
- Reductions in state support from 2001-2004; flat to slightly up in 2005 and 2006; 2007 is looking better, but very state specific
- Shift in responsibility to the institutions themselves, especially for capital funding is leading to large increases in debt.

Various 2005 Rating Changes	Action	From:	To:
▪ University of Michigan	Upgrade	AA+	AAA
▪ University of California	Upgrade	AA-	AA
▪ California State University	Upgrade	A-	A
▪ University of Maine System	Downgrade	AA	AA-
▪ University of Puerto Rico	Downgrade	A-	BBB

Major Issues for 2006

- ◆ Cost Pressures such as utilities & health costs, post-retirement benefits, insurance & building materials.
- ◆ Affordability- rates of tuition increases still exceeding inflation and growing Federal interest in this issue.
- ◆ Tuition discounting still high (never really lowered when economy was strong). This leaves some schools with less cushion to raise aid in an economic slowdown.
- ◆ State Appropriations-better than 2003 and 2004. State revenues are up but still under many pressures (K-12, Medicaid, Prisons).
- ◆ Capital Needs- Competition feeds perceived need for new facilities.
- ◆ Deferred Maintenance- some states are addressing this for their institutions.
- ◆ Increasing Debt Levels to pay for new projects. Some schools are running out of debt capacity or seeing their ratings lowered.

◆ Management & Governance

Major Issues for 2006

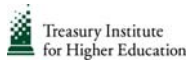
- ◆ Debt service costs having to be incorporated in operating budgets.
- ◆ Larger plant means increased operating costs on top of the debt service. Institutions fixed costs up during periods of high demand, not easily reversed if demand reverses.
- ◆ Higher Interest rates- big increases in short term rates. The “interest rate holiday” for variable rate debt began to end in 2005.
- ◆ Varying Knowledge of Swaps-Closer scrutiny by S&P
- ◆ Continuing diversification of endowment investments-is this with increasing risk?
- ◆ Favorable demand and demographics for a few more years; then what?
- ◆ Improving endowment returns in 2004 and 2005—will this carry over into 2006?
- ◆ Levels of gift giving- giving rose in 2005 but did Katrina legislation drive 2006 gifts into 2005?
- ◆ Competition- for students and flat levels of Federal research \$

Demographics-Concerns beyond 2012

- ◆ By the year 2007-2008, there will be an estimated 3.2 million high school graduates in the U.S.
- ◆ This number is a peak for any year since the end of the post WW-II baby boom
- ◆ The highest number of high school graduates in that year will be in the south (even though the western region will have grown faster)
- ◆ The fastest growing group of high school graduates over the next ten years, by race/ethnicity, will be Hispanic, rising from 295,850 in 2002 to 517,750 in 2012 (+75%)

Demographics-Concerns beyond 2012

- ◆ Long-term Capacity: Overcapacity when the demographic boom ends in 2012 especially at four-year colleges
- ◆ Too much capacity in some markets (New England/Plains states;) and not enough capacity in others (South, Southwest, Western states)
- ◆ In New England, number of high school graduates begins to decline after 2008
- ◆ Overall demand growth through 2008-2012
- ◆ Weakest portion of the sector: tuition dependent, under-endowed colleges and universities




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Management, Governance, and SOX

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Best Management Practices in Higher Education

- ◆ Dissemination and adherence to a strategic plan
- ◆ Integrated modeling of key variables
- ◆ Existence of a long-term capital plan (CIP)
- ◆ Existence of a debt policy (liability management) and investment policy (asset management)
- ◆ Adherence to an endowment spending policy
- ◆ Active board participation and discussions with staff
- ◆ Superior disclosure practices



Disclosure

- ◆ SEC Rule 15c(2)12 filings
- ◆ Sarbanes Oxley
- ◆ Derivatives

Sections of Sarbanes Oxley Act Reviewed In the Rating Process

- Title III: Auditor Independence
 - Section 204 – all critical accounting policies and practices should be discussed.
- Title IV: Corporate Responsibility
 - Section 302 – certification that financial statements do not contain any untrue statement or a material fact or omission of a material fact that makes the statements misleading.
 - Section 303 – unlawful to fraudulently influence, coerce, manipulate or mislead an auditor engaged in the performance of an audit for the purpose of rendering the financial statements materially misleading.
- Title V: Enhanced Financial Disclosure
 - Section 401 – Off balance sheet disclosure.
 - Section 404 – Internal controls report.
 - Section 406 – Adoption of code of ethics.
 - Section 407 – Disclosure of whether at least one member of the audit committee is a financial expert.

Section 404: Internal Controls

Each annual report shall contain an internal control report which states the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting and contain an assessment of the internal control structure and procedures of the company for financial reporting.

Why are internal controls important from a bond rating agency perspective?

- ◆ Loss of financial assets could result from weak or inadequate controls (Balance Sheet impact)
- ◆ Loss of a major revenue source such as grants, contracts or financial aid if policies/procedures are not followed (Income Statement and Enrollment impact)
- ◆ Negative publicity (Fundraising impact)
- ◆ In Global Crossing scandal, finance executive discovered irregular reporting through internal control process BUT the company dismissed the issue after determining that the auditors had signed off on the annual report.
- ◆ In WorldCom scandal, the new CEO requested a review of accounting practices and the internal audit team discovered that the capitalization of assets that should have been expensed

Section 404: Internal Controls (con't)

For bond rating analysts, the following are reviewed:

- Is the audit unqualified?
- Does the entity has an internal control division?
- Are the internal control reports reviewed by a knowledgeable committee? How often?
- What are the credentials of the committee members?
- Does the entity have a compliance committee which is separate from the internal controls committee?
- Has there been any turnover in the financial reporting department? Do not assume that high turnover is a negative.
- Has the entity been in the news for employees involved in fraud/theft/questionable accounting practices?

The controls are only effective if they are periodically reviewed and tested. Therefore, committees with trained professionals are important in determining effectiveness of controls.

Debt Structure and Derivatives

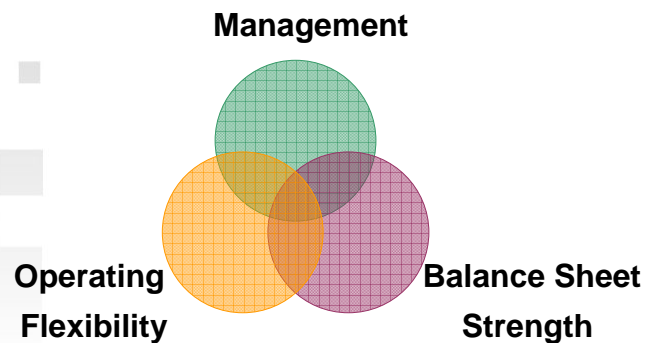
Susan Fitzgerald
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Alternative Debt Structures

- ◆ Traditional
 - 30 year, fixed rate, amortizing
- ◆ Alternative
 - Longer maturities or shorter maturities
 - Variable rate
 - No put risk
 - Liquidity Support
 - Self liquidity

Why alternative? lower cost of capital,
increased flexibility, culture/philosophy

Capacity for Alternative Debt Structures



Maturity Structure

- ◆ Matching of life to life of asset
 - Still paying for obsolete building?
 - Mismatch of cost to students, opportunity costs
- ◆ Interest rate/investment risk
 - Earn more than pay?
- ◆ Philanthropic risk
- ◆ Future management risk
 - Endowment spending, sinking fund etc.

Variable Rate Risks

Two Primary Risks:

1. Put Risk
 - ◆ Structure without put
 - ◆ Liquidity facility
 - ◆ Self liquidity
2. Interest Rate Risk
 - ◆ Budget practices
 - ◆ Asset matching
 - ◆ Derivative instruments



Weighing Benefits/Costs

- ◆ Institution specific
- ◆ All in costs?
 - Staffing, monitoring
 - Various fees
 - Risk management costs
 - Contract/counterparty exposure
- ◆ Can management articulate?