MOODY'S
INVESTORS SERVICE

SPECIAL COMMENT

Governance and Management: The Underpinning of University Credit Ratings

Table of Contents:

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Summary Opinion

Effective governance and strong management are both necessary for the continued viability and competitive positioning of universities as they become increasingly global in scope and compete for students, faculty, research grants, philanthropic support, government funding and tax incentives. In an environment of increased competition for limited public and private resources, governance and management play an ever larger role in Moody's rating approach for U.S. higher education. This report conveys the general framework for our analysis of governance and management, but is not an exhaustive list of best practices. We recognize that governance and management practices will vary significantly depending on the particular credit characteristics and strategy of individual universities. Our analysis of governance and management will continue to evolve with the economic and political environment in which universities operate.

Effective governance and strong management enable an organization to reach its full potential while avoiding financial stress. Strategy, financial health, and credit position are all fundamentally driven by decisions made by a university's board members and leadership team. This report identifies numerous indicators that are well correlated with effective governance and management, providing an analytical complement to traditional quantitative ratios that remain core components of Moody's credit analysis. Over the longer-term, non-quantitative indicators of governance and management are likely to provide equal, if not greater, insights into credit quality than quantitative ratios.

Governance and management assessments often account for a notch or more in the final rating outcome compared with the rating that would be indicated by purely quantitative ratio analysis. The weight of these assessment in our analysis is particularly important when a university is facing strategic change, including: embarking on a major expansion of programs, initiating a significant new borrowing or fundraising campaign, undergoing financial stress or facing a weakening market position, or experiencing high turnover in senior management.

The five broad factors we consider in our rating assessments are:

1. **Board and Senior Management Team Leadership Capability in Stable and Stressful Times**

2. **Oversight and Disclosure Processes that Reduce Risk and Enhance Operational Effectiveness**

3. **Execution of Integrated Short- and Long-Term Plans to Optimize Resource Utilization**

4. **Commitment to Self-Assessment and Benchmarking to Promote Ongoing Improvement**

5. **Effective Management of Government Relations to Encourage Future Support**

Moody's weighs the effectiveness of governance and management partly through comparative assessments across the higher education industry. Our industry insights are derived from our extensive market coverage of higher education in the United States. Moody's rates more than 500 public and private universities, which account for more than 90% of enrollment in four-year public universities and more than 70% of enrollment in four-year not-for-profit private universities. In our published rating reports, we provide discussion of our assessment of governance and management to explain our rating opinions. The depth of the discussion and points of emphasis will vary based on the particular credit issues facing the college or university.

1) Board and Senior Management Team Leadership Capability in Stable and Stressful Times

University board members and senior managers face the complex challenge of executing the university's charitable mission while safeguarding and growing its financial resources such that the organization's viability is maintained over the long-term. Moody's believes that the composition of a university's leadership is the foundation for organizational effectiveness.

The board of a private, not-for-profit college or university retains the ultimate authority in setting the strategic direction, unlike a for-profit corporation whose board derives its authority from the clear goals of equity holders. Not-for-profit boards are affected by multiple goals of key stakeholders, notably alumni, donors, students, but especially the faculty who traditionally seek to share in some aspects of governance of the university. The concept of "shared governance" with employees (i.e. faculty) is largely unknown outside of higher education, although the relative role of faculty in governance is likely to erode as universities face more pressure to be efficient in the competitive market for resources. In addition, whereas corporate board members are often well compensated for their service, private university board members are often asked to provide substantial donations to demonstrate leadership and commitment to the university.

A public university board's authority may be even more ambiguously derived--reflecting not only the views of faculty, students, and alumni, but also the diverse policy goals and political aspirations of a state's elected leaders. In most states, board members continue to be appointed by elected officials and receive little preparation for the complex tasks facing them. Moody's has observed substantial variation in the degree to which governance is shared between legislative bodies, the executive branch, and public university boards. Notable tensions can develop between the board's fiduciary responsibilities and competing state interests on various fronts including the ability to set tuition and fee prices, to regulate the mix of resident and out-of-state students, retain surpluses, manage investments, and refine the university's mission. While state financial support appropriately comes with certain conditions and expectations, we view the board's flexibility to adequately manage the university as a credit strength. In light of growing financial and policy challenges, public university governance is likely to evolve toward a hybrid model where more members are appointed based on their expertise and philanthropic potential, rather than mainly because of their relationship with elected officials or connection to the political process in the state.[1]

We examine a number of critical factors when assessing the board composition and senior management of a university, including:

- Mix of tenured and new members with knowledge of institutional history as well as external best practices and strategies--thereby ensuring continuity as well as adoption of new perspectives
- Board members who provide material philanthropic support as well as expertise in the areas of risk management, financial statements, multi-year financial and capital plans, and investment strategies
- President who demonstrates clear understanding and leadership on financial and capital matters as well as the university's academic and research mission
- Strong chief financial officer and other vice presidents who demonstrate independent expertise and mastery of multi-year financial plans, budgets, and financial statements
- Leadership with diverse experience both inside and outside the university, including some experience from business and government in addition to the higher education industry

Moody's reviews written materials that cover the professional backgrounds and years of tenure of each individual member of the board and senior management team. We discuss the composition and structure of the board and its committees, the procedures for selection of new board members as well as the president, and division of responsibilities. When warranted, we request a conversation with key board members.

2) Oversight and Disclosure Processes that Reduce Risk and Enhance Operational Effectiveness

Clearly articulated policies and division of responsibilities provide evidence of transparency, accountability, and oversight. Effective internal controls can alert management to potential problems and help to minimize any negative impact on the university's financial health. Effective internal controls are necessary for maintaining accreditation, federal financial aid eligibility, grants, contracts, and donor confidence. Moody's believes that a board should review internal controls to ensure they remain both supportive of the university's mission and relevant to the financial operations of the university. Additionally, we believe that external public disclosure of policies, budgeting practices, projections, and long-term plans help ensure accountability to key stakeholders such as board members, students, alumni, donors, bondholders, community members, and accrediting agencies.

Effective internal controls and timely external disclosure about student outcomes, research productivity, financial performance, and organizational efficiency will become the hallmark of effective university leadership and will become increasingly critical in mitigating new risks to individual universities and the sector overall.

1 Public University Governance Faces New Challenges as U.S. Public Higher Education Becomes Increasingly Market-Driven, May 2008

We examine a number of critical factors when assessing the internal controls and external disclosure of a university, including:

» Board approved policies on investments, debt, liquidity, and conflicts of interest

» Detailed disclosure and transparency for internal decision makers and external stakeholders

» Appropriate staffing for effective implementation of policies

» Frequent board oversight of the president, including annual performance assessment by multiple board members who rotate over time

» Use of internal audit function that reports to the board

» Detailed disclosure on university website regarding student outcomes, financial statements, research activity, budgets, compliance with bond covenants, and other material issues

» Filing of financial statements within 90 days of the fiscal year end, including detailed management discussion and analysis

» Availability of quarterly statements or interim information for larger research and endowed universities, as well as those with healthcare operations

» Clearly defined board committee structure and responsibilities

» Term limits for board members

Moody's reviews a university's written policies, assesses presentations made by management to the board, and discusses staffing and processes for risk management with members of senior leadership. We look for the board to develop and routinely review key policies overseeing the university's investments, debt, operations, and compliance-related issues. We also examine information made available to external stakeholders through web sites, financial statements, and official statements associated with debt issuances.

3) Execution of Integrated Short- and Long-Term Plans to Optimize Resource Utilization

Effective utilization of a university's resources requires a long-term strategic plan, a long-term financial plan, prudent short-term budgeting, and the continuous alignment of all three. Universities are perhaps the most capable long-term planners among all industries, adopting and executing multi-decade campus development plans, long-term endowment investment strategies, as well as other long-range strategies. Planning is critical given the institutional imperative to fulfill a stated mission in an environment of changing student demographics and financial constraints, coupled with increasing external stakeholder scrutiny (tax-exempt status, accreditation, community relations). Moody's believes that these plans should incorporate detailed conservative, but realistic assumptions. Budgets and plans that are overly conservative or optimistic provide limited value in indicating the organization's real potential and management's ability to achieve its goals without causing financial stress.

We look for a number of critical factors and use of best practices when assessing the plans and planning process of a university, including:

» Integrated strategic, capital, and financial plans

» Use of detailed multi-year financial plans and budgets that tie to audited financial statements

» Conservative budgeting, producing consistent operating surpluses

» Financial and capital scenario evaluation and stress testing

» Prudent endowment management and sustainable endowment spending policies that are regularly reviewed in context of overall university risk assessment and multi-year financial plan

» History of meeting or exceeding internal forecasts for budget performance, enrollment, and fundraising

» Recognition of key risks in multi-year plans and development of contingencies for addressing them

Moody's reviews a college or university's written strategic plan, master facilities or capital plan, as well as mid-range and long-range budget projections (five to ten years). Moody's analyzes budget-to-actual results for enrollment, fundraising, investment returns, and operational performance. We examine management's assumptions used in projections as well as use of stress testing scenarios.

4) Commitment to Self-Assessment and Benchmarking to Promote Ongoing Improvement

Self-assessment provides governing boards and management teams with the tools to identify challenges early on and to develop strategies to address those challenges in the interest of maximizing efficiency. External benchmarking is of particular importance in light of increasing competition for students, grants, and philanthropic support. Moody's believes that the most successful organizations follow best practices in self-assessment, including use of a short list or "dashboard" of key metrics that are closely monitored on a regular basis to identify adverse trends quickly and development of contingency plans to make mid-year adjustments when necessary.

We examine a number of critical factors when assessing the self-assessment and benchmarking process of a university, including:

» Benchmarking relative to best practices and strategies across higher education sector

» Existence of key performance indicators that are regularly monitored

» Development of well considered contingency plans

» Regular performance reviews and assessment of the college president and senior leadership

» In-depth institutional research and evaluation of competitive landscape

Moody's reviews the metrics and set of peer organizations by which a university chooses to measure itself. Well managed organizations compare themselves against a carefully selected set of peers rather than only to an 'aspirant' peer group that is likely to reflect hope and image over substance. We discuss with management the frequency and depth with which the information is reviewed by senior leadership and board members. We also inquire about examples of leadership actions based on a university's performance relative to key indicators to understand its willingness and ability to react to developing situations.

5) Effective Management of Government Relations to Encourage Future Support

Many external stakeholders can directly affect the financial position of universities through their potential to restrict access to capital, reduce tax subsidies, or increase regulatory oversight. A university's relationship with government is perhaps paramount due to the importance of securing continued financial support in the form of federal student financial aid, research awards, and continuation of tax-exempt status. To help ensure a supportive relationship from key stakeholders, colleges and universities increasingly must clearly articulate the economic benefits they provide to the nation, state, and region—including their roles as educators of informed citizens, trainers of the future workforce, creators of new science and technology, generators of new business development and technology transfer, large-scale employers, and providers of cultural enrichment.

Public and private universities face overlapping challenges and opportunities with regard to government and community relationships. Private universities, especially those with large research functions, providers of substantial healthcare operations, or those operating in states that offer material financial aid grants to students, are susceptible to direct funding risks from by state and federal governments. Public universities, although not as independent as 501(c)(3) private universities, are quickly becoming market-driven public-mission organizations, much like their private not-for-profit peers. As public funding continues to diminish as a percentage of their total budget, these rapidly evolving and complex organizations require increased operating freedom and a more flexible oversight structure in order to fulfill their missions.

In most nations outside of the United States, universities are primarily funded and controlled by the government, so effective management of government relations is of primary importance for the university's financial future. Our global rating methodology for universities outside the U.S. reflects a government-directed model of higher education.[2] In the U.S., we generally view increased university autonomy as a credit positive because it tends to promote more efficient resource utilization and effective execution of long-term plans, which are critical for universities to succeed in the highly competitive higher education market. However, we still recognize that governmental financial support, which appropriately comes with certain conditions and expectations, can strengthen the credit quality of a university. Consistent funding for operations and capital, extraordinary financial support driven by particular events (eg: natural disasters or institutional scandals), and programs to support higher education debt issuance, can contribute to the fiscal health of an organization.

[2] Methodology for Rating Public Universities, August 2007

We examine a number of critical factors when assessing the government and stakeholder relationship of a university, including:

» Political autonomy from the state in key areas, including ability to set tuition and fees, regulate mix of in-state and out-of-state students, retain surpluses, and manage investments

» Consistent state financial support for operations and capital projects, particularly during times the state is experiencing economic challenges

» Evidence of stable and supportive relationships with the local community including lack of contentious debate or proposals over local taxes

» Substantial local/regional economic impact of the university

» Special programs which provide additional support for public higher education such as debt service reimbursement from the state, intercept programs, and funds established to support a specific university or higher education in the state at large

Moody's evaluates the political and regulatory environment in which a university operates and looks for examples of the limitations or flexibility in navigating particularly challenging situations. Moody's reviews legislative and statutory changes as well as the political discourse that could affect colleges and universities. In addition to monitoring news coverage and leveraging the research of Moody's state and local government analysts, we discuss the political landscape with university management teams.

Moody's Related Research

Special Comments:

» Liquidity and Credit Risk and Endowed U.S. Universities and Not-for-Profits: Ratings Focus on Institutional Governance and Management of Interrelated Risks, June 2010

» U.S. Higher Education: Greater Disclosure and Transparency Will Likely Build Market Confidence During Credit Crisis, June 2009

» Public University Governance Faces New Challenges as U.S. Public Higher Education Becomes Increasingly Market-Driven, May 2008

» Management of Endowments Grows Increasingly Challenging: More Complex Strategies Require Improvement in Governance and Oversight, May 2007

» Moody's Approach to Analyzing Governance of Private Higher Education and Not-for-Profit Organizations, December 2004

Rating Methodologies:

» Moody's Rating Approach for Private Colleges and Universities, September 2002

» Public Colleges and Universities, November 2006

» Methodology for Rating Public Universities, August 2007

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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