

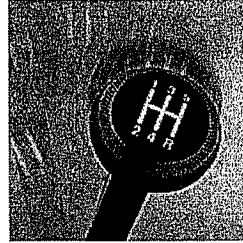
REVERSAL OF MISFORTUNE

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When the market hit bottom, Dominican University's banking relationships and aggressive growth plans also stalled. A solid financial risk management strategy put the institution back into forward gear.

By Amy McCormack and Richard Walstra

We had a plan. In fact, we had a specific, ambitious strategic plan approved by our board in 2002. It called for enrollment growth driven by several capital projects that would be supportive of the strategic priorities—the complete renovation of our library; enhanced technology; a new residence hall to support increases in the residential population; and, most importantly, expansion and enhancement of academic spaces, especially science facilities. In addition, the village of River Forest, Illinois, where Dominican University resides, was requiring the university to significantly expand parking, which resulted in a new parking garage. All of this was to be supported by a major capital campaign and a pair of bond issuances.



The plan worked. We built it all, and they came. Over the past eight years, we invested more than \$80 million in facilities, nearly doubling our campus's square footage. Student headcount increased 89 percent over the past 10 years, growing from 2,068 students in 1998 to 3,909 students in fall 2009. We fully anticipate that we will surpass the 2012 goal of 4,000 students by fall 2010—two years ahead of schedule.

These dynamics created a number of competing pressures. Growth at both the undergraduate and graduate levels, along with accreditation standards, brought demands for additional full-time faculty. In addition, the undergraduate growth carried with it corresponding increases in financial aid and a freshman discount rate that continued to creep higher.

Meanwhile, interest on the new debt and depreciation on the additional assets were absorbing much of the revenue increases. Cash flows became much more dynamic and vulnerable to unpredictable swings due to the uncertain timing of campaign pledge receipts and large cash outflows on the capital projects. Yet new bond covenants called for steady liquidity and much tighter control and forecasting of cash flows. Despite these factors, we progressed along, all seemed manageable, and we could see the light at the end of the tunnel.

But you know what they say about the best-laid plans. In fall 2008, the economy took a huge tumble, with particularly harsh implications for the banking industry and the investment climate. The fallout caused significant uncertainties surrounding enrollments, fundraising, investment returns, financing, and cash flows.

These turbulent economic times have forced many smaller institutions like ours to quickly learn and practice financial risk management. And that's what we've been doing. By identifying and focusing on key areas, we've made substantial progress in recovering from the misfortune that overshadowed our optimistic plans. Following is the way things have unfolded.

THE BOTTOM DROPS OUT

While Dominican University was going from good to great, our banking relationships were literally going from good to gone. In September 2008, we were in the process of renewing a

letter of credit (LOC) on an \$11 million bond, when our credit provider decided that to preserve its capital, the bank wanted to exit our relationship. At the most credit-adverse time in recent history, Dominican was left with finding a replacement. The granted four-month extension came with a near doubling of the LOC fee.

Meanwhile, due to the freefall in investments, our endowment level dropped as much as 30 percent and we missed a year-end cash and investment covenant requirement on a \$30 million bond. Although the credit provider granted a waiver on the covenant, the waiver fee more than doubled that LOC fee, too. Further, the small local bank that held our operating accounts as well as a privately held \$5 million bond experienced an extreme decline in capital, which created risk management concerns for the university. One of the covenants on the bank-held bond required that the operating and payroll accounts be maintained at the same bank that held the bond, which limited our flexibility in seeking a comprehensive solution with another bank.

As the decade of growth and expansion of facilities and debt moved toward a close, we faced still another challenge. We needed to ensure that the university's quantitative growth was matched by qualitative success and that we could return to a period of financial stability following this time of mayhem.

VULNERABILITY PROMPTS PROTECTIVE MEASURES

Our priority for the past 18 months or so has become financial risk management. Along with our board, the president and other senior administrators put the focus on contingency planning, debt restructuring, student retention strategies, and overall risk management.

Contingency planning. Every year, the board mandates a 1 percent budgeted surplus as a contingency, but we felt it was necessary to increase this amount to 1.5 percent for the next three to five years to build liquidity and reserves. We were dealing with several variables:

- o **Unpredictable enrollment.** Historically, graduate enrollment increases during economic downturns, but with such a far-reaching economic meltdown, we could not count on that. Therefore, we budgeted for only 97 percent of the graduate enrollment forecasts.

Slightly more than 95 percent of our undergraduate student body relies on financial aid, so we were worried that financial constraints might affect enrollment. As a contingency on this enrollment factor, we reduced the projected number of new freshmen.

- o **Student aid questions.** We expected that there would be an increase in the freshman discount rate, which had been at 41.5 percent in the prior year. In fact, the rate increased to 44.7 percent in the past year.
- o **Fluctuating endowment.** One of the university's priorities has been to increase endowment to further support student financial aid and the increased costs associated with higher accreditation standards. Over the past 12 years, the university has increased its endowment from a meager \$3 million to \$20 million (a figure that dropped during the 2008 downturn but has since recovered).

To preserve endowment, we cut the 5 percent spending rate in half and did not draw from those donor accounts that were underwater—more than one third of the accounts, during the worst of the crisis. Continuing this trend throughout 2010 further protects our endowed funds. This was one of those rare times when we were thankful that we didn't rely too heavily on our endowment.

Staffing issues. Compensation represents our largest expense category: 64 percent of expenses, excluding financial aid. Because of the recent enrollment growth, it has been essential that we continue to hire faculty to avoid a decline in the student-faculty ratio. However, recent budget pressures, intensified by our rapid growth, have limited our opportunity to keep up with staffing.

To strike a reasonable balance, we approved several new faculty positions as priorities for FY10 while limiting new staff

**CALCULATING A MULTIYEAR
COMPENSATION PLAN**

positions—some of which were deferred until 2012—and in the effective date of the enrollment. We committed to a 2 percent increase in salaries for all faculty and staff, but deferred the effective date to October (versus September) to ensure that enrollment would support such an increase. Most importantly, senior-level staff, including the president, vice presidents, and deans, did not receive any salary increases.

Looking ahead, the university is developing a multiyear faculty compensation plan to improve the American Association of University Professors (AAUP) levels of our faculty by rank. (See sidebar, "Calculating a Multiyear Compensation Plan.")

Overall contingency planning continues with an exercise that looks at three different scenarios: one with a decline in enrollment; one with an increase in enrollment and financial aid, resulting in no additional net tuition; and one that achieves further growth but triggers additional capital expenditures. As another contingency measure, we evaluated all staff positions to determine opportunities to reduce some positions to 10 months per year or have reduced summer hours. We are also reevaluating any vacancies that arise to determine whether or not they can be converted to 10-month or part-time positions.

Debt restructuring. Since 2000, the university has taken on a significant amount of debt, with borrowing levels reaching \$46 million on an asset base of \$120 million. The need to grow the physical plant and to use debt as a tool to accomplish growth targets was an important element of the strategic plan. Multiyear financial modeling, including the Council of Independent College's Financial Indicators Tool (FIT) and Key Indicators Tool (KIT), has been used to target long-term financial goals and prioritize financial planning. (For more details on the CIC tools, read the *Business Officer* article, "Diagnosing Fiscal Fitness," in the April 2009 issue.)

The goals are to ensure interest expense does not exceed 7 percent of the operating budget, to increase liquidity, and to continue to prioritize debt retirement. Financial modeling has told us, for example, that by FY10 to FY11 our interest and depreciation costs would plateau, easing the budget pressure and allowing us to pursue the faculty growth and compensation plan discussed above.

The model has also demonstrated that the increased depreciation built into the budget creates additional cash flows, which are available for debt retirement. As expected, our ratios have declined as we have taken on additional debt while waiting for pledge payments. However, we have started to incorporate our strategic planning priorities through 2014, which include another comprehensive campaign focused on building endowment. Based on assumptions about operations, the campaign, and implementation of the campus master plan, the ratios are expected to return to healthy levels by 2014.

Part of our multiyear plan is to address equity salaries using American Association of University Professors (AAUP) data and, over the past few years, our salaries have dropped in comparison to those of our peer group. We decided that we needed to develop a multiyear plan to address faculty by rank and salaries overall. The goal of this plan was to bring all individual faculty up to at least 90 percent of AAUP Level 3 by rank by February 2012 and to ensure the average for faculty salaries by rank was at 100 percent of Level 3.

The plan includes four components.

Equity adjustments by rank. A minimum salary by rank is established, and appropriate adjustments are made to any faculty below the minimum

Annual cost-of-living adjustment that would apply to all faculty and staff. The cost-of-living adjustment is based on the consumer price index, but with a goal of exceeding that index.

Flat-rate increases by faculty rank. These are calculated as a lump sum midyear adjustment that would be dependent on achieving enrollment goals. The flat rates vary by rank, with professors receiving the greatest flat rate adjustment because they are the furthest behind. As new faculty are hired at the assistant rate, the variances between the average salary by rank and the averages for AAUP Level 3 will not be as great as they were at the professor level.

Merit pool, if surplus is achieved. The idea is to reward faculty for extraordinary work, such as publishing a book.

We see funding the multiyear plan as a priority for resource allocation, which means making some tough decisions. We will forgo hiring and other expenditures to allocate funds to what we see as one of our strategic priorities. If we aren't able to improve our faculty salaries compared to our peers, we risk our ability to continue to recruit and retain talented faculty. Teaching is, after all, our primary task.

As of press time for this article, the first two components have been implemented, and based on preliminary data for spring enrollment, it appears we will achieve our enrollment goals and proceed with the flat-rate increases scheduled for this month.

When the financial crisis hit, the refinancing of our two smaller debt instruments was a significant challenge—credit tightened globally, and consequently large banks could select optimum clients while smaller banks faced new limitations on lending capital. While diversifying banking relationships, swap providers, and remarketing agents was once wise financial management, the new paradigm is that every bank wants *all* the business, and credit can be dependent on such a package deal.

The use of long-term variable-to-fixed rate swap instruments, which also made sense in a low interest rate—flat yield curve environment, limited our flexibility in crafting a solution to our debt needs. The swap instruments were underwater, so exiting them would be a costly proposition. Fixed rate debt seemed appealing but conflicted with our swap structure. Letter of credit backed—debt had become more expensive and harder to find in the new banking environment.

We approached numerous banks regarding a new relationship. Several expressed interest because of the university's positive indicators of strategic planning, stable and capable management, proven growth and fundraising ability, and past history of producing annual surpluses. However, credit committees were tightening and taking very few risks. It appeared to us that every factor we could control had met or exceeded our goals, and yet those factors that we couldn't control, like the market, were currently being valued more than past performance. After nine months of discussions with more than 15 financial institutions, we finally negotiated a very attractive refinancing with a reputable, stable regional bank that had a local branch eight blocks from campus.

Student retention. Dominican University is small, but the management is fairly complex, with enrollment evenly split between undergraduate and graduate programs comprised of library and information science, business, education, social work, and leadership and continuing studies. While the student headcount is evenly divided, the undergraduate full-time equivalents (FTE) represent two thirds of the enrollment; and of the undergraduates, 40 percent are first-generation students. Tuition and room-and-board fees comprise 92 percent of the \$70 million budget, with less than 1.5 percent being supported by endowment income.

With the recession making enrollment uncertain, we took a number of steps:

- o Reduced our enrollment forecast, not only focusing on new students, but running models with a goal of increasing our retention.
- o Formed a student retention committee that examines underlying retention issues for each and every student.
- o Focused on evaluating classroom size and closely monitoring student-faculty ratios.
- o Reviewed—and will continue to review—student satisfaction surveys annually. We've learned that our students rate their relationship with faculty much higher than do students at other four-year private institutions, based on data from the National Survey of Student Engagement (NSSE). Our faculty are also aware that student-faculty interaction is an important component of retention.
- o Introduced tuition incentives. As a specific response to the weak employment market, the

ANNUAL NACUBO ACCOUNTING FORUM DETAILS CURRENT AND COMING ISSUES

The Higher Education Accounting Forum is one of NACUBO's most popular workshops. Taking place April 18–20 in Chicago, the event offers the latest information on trends, issues, and best practices in financial and managerial accounting and reporting, budgeting and financial analysis, and tax for all types of institutions.

Designed for advanced-level accounting and finance professionals, a number of session formats—including plenary presentations, breakouts, and roundtables—allow for networking with colleagues and speakers. Roundtable exchanges are segmented in a way that brings together participants from like institutions to share ideas.

The forum serves as an annual update on accounting and finance in higher education and provides perspective on the future outlook and implications for the business office. Participants hear and engage in discussions on timely subjects affecting the higher education accounting community. The agenda includes FASB, GASB, and tax updates as well as sessions on liquidity, the economy, and higher education's outlook. Other topics to be covered include resource challenges, ratios, fair value, endowments, technology, auditing, federal regulatory issues, and performance measurement.

For additional information and to register, go [here](#).

university initiated a program in January 2009 that offers graduates a 10 percent tuition reduction toward any of our five graduate programs. This "education stimulus plan" allows undergraduate students to continue with schooling rather than struggle in a difficult labor market. The program was continued through January 2010, and has met the needs of more than two dozen students.

A specific retention initiative that the board approved for FY10 was a loan-to-grant program. The loans were for amounts up to \$3,000 and would be forgiven upon graduation. To qualify for the loan, the student had to be in good academic standing and indicate a recent change in financial situation causing greater financial need.

The institution has been forced to increase its freshman discount rate to almost 45 percent. Although necessary during the past year to achieve freshmen numbers, the higher discount will not be sustainable for the long term. Interestingly, most of the additional aid in the current year went toward top-end scholarships, not need-based grants. This seems to reflect a market dynamic of top academic students in the large Chicagoland pool staying closer to home. We continue to analyze and test financial aid models in an effort to lower the discount rate over the next few years.

Overall risk management. The institution is monitoring 20 different indicators of risk and trying to address areas in which the university is vulnerable—such as tuition dependency, discount rate, percentage invested in technology, and funding reserves for deferred maintenance. Annually, the business office updates this summary and shares the information with the board's audit and risk subcommittee. For example, as of now, we've identified six areas that need improvement. The board discusses each area and identifies strategic measures to improve such areas.

The university is also focused on items that can affect reputational risk, such as student-faculty ratio, percent of courses taught by full-time faculty, and faculty salary levels that allow the university to compete for the best faculty.

Less quantitative, but equally important, are risks associated with crisis management. We established a "behavioral concerns" committee to identify students who could pose a danger to themselves or the institution. Clearly, actions related to this area could have quite a negative effect on reputation. Faculty, staff, and fellow students are encouraged to report any behavioral concerns. Reports are then shared among members of this small committee to identify risks and develop appropriate responses.

Another risk to which we have been sensitive is diminished employee morale. In trying times, we needed our staff to be more productive than ever—despite their own reactions to the crisis. Internal communication became a priority and continues to be so. While it is likely most faculty and staff feel a sense of job security, the external environment and the drop in the stock market produced anxiety among all constituents. We soon learned that sharing accurate information, although the message is not always positive, is important.

Our university leadership team sought out and identified multiple communication opportunities and strategies to employ with students, faculty, staff, and the board. Periodic updates were given at academic council meetings as well as staff assemblies. Monthly memorandums sent with the internal financial statements were used to update the budget committee and the finance and executive committees of the board. A presentation at the board retreat on contingency planning and identified risks was used to make sure the full board was informed and had the opportunity to ask questions.

It is obvious to us that steady and honest communication has played a key role during the worst of our financially challenging times. All our stakeholders remained well informed and seemed appreciative of the efforts and planning required to keep them in the loop. We felt that, in large part, we all managed the financial misfortunes and mishaps together.

POSTSCRIPT TO THE CRISIS

Dominican is currently in a good place. We exceeded our new-freshman projection in fall 2009, and graduate enrollments were quite strong. The endowment fund, which was down 20 percent during FY09, has recouped most of its market value. Last November, we identified a new bank to refinance two previous bond issuances with a new, unsecured, variable-rate bank bond. That financing has been completed, and we have transitioned our operating accounts to that bank. Of course, challenges remain as we prepare to launch the next generation of our strategic plan. Data gathering and financial modeling will play a significant role as we move forward to ensure informed decision making that will provide a successful and sustainable future for Dominican University and our students.

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