MUHLENBERG COLLEGE

DEBT POLICY

March 2005

I. Overview

In order to fulfill its mission and to achieve strategic objectives, the College will need to periodically invest in capital projects and improvements. The College can fund capital projects and improvements through a variety of methods, namely gifts, operating revenues, reserves and debt. Just as gifts are a permanent component of the College's assets and operating revenues are a critical component of income, debt will be viewed as a perpetual component of the College's liabilities. Viewing debt as a perpetual component of College liabilities is a change to how debt has been regarded by the College in the recent past. Over the long term, debt likely provides the College with the lowest cost source of capital to fund strategic initiatives. The policy has been designed in light of the College's desire to utilize the lowest cost of capital within the construct of the College's financial position, financing goals, and risk preferences.

II. Scope of the Policy

This policy applies to the use of tax-exempt or taxable debt to finance College strategic initiatives and associated analyses.

III. Scope of Authority

The debt policies discussed herein provide the framework within which decisions will be made concerning the use and management of debt. The policies are structured to set outer bounds for the College's capital structure to ensure that the College incurs debt in a fiscally responsible manner while still providing management and the Board of Trustees with the flexibility necessary to meet the College's educational mission and to execute transactions in a financially efficient and timely manner.

As the Board of Trustees or Chief Financial Officer deems necessary, prudent, or helpful, the Finance Committee may provide further guidelines to serve as points of reference to assist management and the Board in making appropriate decisions regarding the use and management of debt. Unlike these polices, the guidelines will not be hard and fast requirements that compel or prevent a particular debt-related decision, but rather data points that deserve strong consideration in the decision-making process. College management and the Board of Trustees must continually have the ability to make judgments on a case-by-case basis as to the use and timing of debt and what form the debt will take given the specific project under consideration. In the event that the College would like to consider a transaction that would otherwise violate a policy contained herein, the Finance Committee will review the transaction and submit a recommendation to the full Board of Trustees for the Board's consideration. The Board will follow its normal decision-making process in determining whether to move ahead with the transaction.

The Debt Policy will be reviewed by the Board of Trustees at least every two years and modified as necessary to reflect changing conditions and risk preferences.

IV. Debt Policies

A. Use and Management of Debt

Given that the College does not have unlimited borrowing capacity, management will allocate the use of debt with the approval of the Board of Trustees. This will include a prioritization of debt resources among uses (i.e., academic projects, equipment financing, real estate investments and other projects) and management of the College's debt portfolio in accordance with the policies set forth below.

Prioritizing the Use of Debt

1. Projects related to College's core mission (revenue producing or not) will be given the highest priority to be financed with debt;

2. A project not directly related to the College's core mission with a related revenue stream will be given priority consideration. For these types of projects, the use of debt must be supported by an achievable financial plan that includes servicing debt and meets any new or increased operating costs, which could include the funding of a replacement and renovation reserve fund.

3. Projects that create budgetary savings (i.e. refundings) will also be given priority consideration. The College will consider a refunding transaction that produces 3% net present value savings (net present value savings as a percent of new bonds issued). For projects that produce budgetary savings, the budget will be reduced to reflect the decrease in debt service and any savings may be invested into other capital projects, the endowment or current and plant assets.

4. When advantageous, the College will also consider restructuring outstanding debt to relieve the College of certain limitations, covenants, payment obligations or reserve requirements that reduce flexibility. Candidates will be reviewed by the Board of Trustees and management on a case-by-case basis with a weighing of savings or loss versus increased flexibility. Further, the College may elect to refinance certain smaller obligations in order to more efficiently manage the balance sheet by consolidating obligations and reducing the administrative burden of managing smaller obligations.

Managing the College's Debt

1. The term or final maturity of debt will be based on the asset being financed, the College's balance sheet, development initiatives and other circumstances when issued.

2. The College will review its budget when determining the amortization method of new debt (e.g., wrapped debt service, level debt service and bullet maturity). The College can elect to reamortize bonds that are being refunded or restructured on a schedule that differs from their original amortization schedule. Call features should be structured to provide the highest degree of flexibility relative to cost.

3. The College will use a limited number of core financial ratios to assist in capital planning, debt management and strategic decision making. The core financial ratios are:

   i. Balance Sheet Ratio – Expendable financial resources to debt = measures availability of assets, excluding permanently restricted net assets and net plant assets, to cover debt should the College be required to repay all of its outstanding obligations immediately.

Total unrestricted and temporarily restricted net assets less net investment in plant / Total outstanding debt

The College will maintain this ratio equal to or greater than 1.0x.

ii. Income Statement Ratio – Annual debt service to operations = measures the relative cost of outstanding debt to operating expenses.

Annual Debt Service / Total operating expenses

The College will maintain this ratio equal to or less than 12%.

iii. Variable Rate Allocation Ratio – Measures allocation between variable rate debt and fixed rate debt.

Total variable rate debt / Total debt

The Variable Rate Allocation Ratio should change over time in response to changes in a) outflows driven by total debt service and b) inflows driven by the long-term performance of interest rates, the stock market, and other factors affecting the investment income that the College uses to offset debt service payments. The College should take these factors into consideration to determine the appropriate levels of variable and fixed rate debt. The College will be mindful of this ratio, but the focus of the risk analysis with respect to variable rate date will be driven more predominantly by the measure of unhedged variable rate debt, as described in more detail below.

B. Use of Variable Rate Debt

Due to the financing flexibility and typically low interest cost associated with variable rate debt, it is desirable to maintain a portion of the College's aggregate debt on an unenhanced, variable rate basis. However, the use of variable rate debt exposes the College to certain risks that are inherent to variable rate structures. The College will consider these risks when determining whether variable rate debt is an appropriate financing vehicle:

1. Credit risk: the risk that the party providing credit enhancement or liquidity (a commercial bank or College in the case of variable rate demand obligations or "triple-A" municipal bond insurer in the case of Auction Rate Certificates) experiences credit problems that adversely impact the marketability of the College's variable rate bonds.

2. Liquidity risk: the risk of a failed remarketing. In this instance, the liquidity provider becomes the owner of the bonds, the College pays debt service at a taxable rate and the bonds are retired on an accelerated basis. Expiration dates for credit facilities (direct pay letters of credit or standby bond purchase agreements) do not typically exceed five years, and there exists the risk that the College may not be in a position to either renew its existing credit facility or have access to a high-quality replacement credit facility. This circumstance could exist because of credit difficulties with either the credit facility provider or the College. Even if the College has access to an acceptable credit facility the risk exists that the price may increase (pricing risk). Renewal risk and pricing risk do not exist for

Auction Rate Certificates since the credit enhancement (municipal bond insurance) is paid one-time at closing and is irrevocable so long as the bonds remain outstanding.

3. Budget risk: the risk that the actual variable interest rate exceeds the budgeted interest rate.

4. Overall cost of funds risk: the risk that variable rates will rise above the level of the College's risk tolerance and increase interest costs throughout the term of the debt. The impact of volatility on incremental variable rate debt is larger on the downside (increased borrowing costs) than on the upside as illustrated by the fact that nominal rates can never drop below 0% but theoretically can increase an unlimited amount.

In considering the use of variable rate debt, the College shall consider the amount of short-term investments, cash reserves and current and plant fund assets available since the earnings from these funds can serve as a natural hedge offsetting the impact of increasing variable rate interest cost.

The College will maintain its unhedged variable rate exposure at no more than 15% of total outstanding variable rate debt. For this purpose, unhedged variable rate debt is defined as principal of any variable rate debt less: 1) the amount of direct variable rate debt (notional amount) that is subject to an interest rate exchange agreement (synthetic fixed rate swap) or interest rate cap, collar or other hedging mechanism and 2) the amount of short-term assets and current and plant funds within the College's investment portfolio. Short-term assets are, for this purpose, defined as: a) cash and cash equivalents and b) the market value of other investments with maturities of 30 days or less.

C. Use of Derivative Products

Derivative products (e.g., interest rate swaps, caps, collars, forward starting agreements, etc.) can effectively lower costs, reduce and diversify certain risks and manage variable rate exposure. The Board of Trustees and management will evaluate derivative products and their associated risks and benefits on a case-by case basis and prior to executing any transaction. The College will determine if it is being compensated appropriately for any risks it assumes.

The College's strategy regarding the use of derivatives will seek to balance risks and rewards; therefore, transactions that impose a relatively higher degree of risk will require a greater expected benefit. The College's use of derivative products will be evaluated according to the following criteria:

1. Articulate objective of the proposed transaction (i.e. portfolio management, manage variable rate mix; manage interest rate risk, etc.). The risks and benefits of the transaction will be analyzed. The most common risks are (in addition to credit and liquidity risk discussed in "C" above):

   a. Market and termination/collateral risk: the risk that the swap could be terminated or the College could be forced to post collateral as a result of any of several events including a ratings downgrade of the swap counterparty or the College, covenant violation by either party, swap payment default by either party and defaults defined in the College's bond indentures. Swap agreements are terminated at market. Termination may require that a payment be made to the College or may result in the College making a payment to the counterparty, depending upon market conditions at time of termination. Depending upon the event trigger, the College may be forced to post collateral in lieu of market termination. The College shall consider the following factors when negotiating an ISDA Master, Schedule and Credit Support Annex, drafting the structure of any swap agreement and negotiating the Confirmation:

i. Use of insurer to guarantee swap payments and swap termination payments;
ii. Swap duration;
iii. Termination payment methodology (i.e., first or second method, market quotation or loss);
iv. Cross default provisions (parity debt, subordinate debt or other debt);
v. Lien on termination payments (parity or subordinate)
vi. Source of termination payments (College funds or revenues);
vii. Provision for payment termination fee (term-out or lump sum); and
viii. College-controlled optional termination provisions.

b. Counterparty risk: the risk that the swap counterparty will not perform pursuant to the terms of the swap agreement. The College shall require, appropriate collateralization and/or third-party guarantees and/or a mechanism for replacement of the swap counterparty in the event of a rating downgrade in the Credit Support Annex. Only counterparties with appropriate credit will be utilized. The greater the College's reliance on the counterparty's credit (i.e. length of the transaction, type of the transaction, future payment requirement), the higher the minimum acceptable counterparty credit. As a guideline, the College shall consider counterparties with ratings in the double-A rating category from both Moody's and Standard & Poor's, respectively.

c. Basis risk: the risk that there is a mismatch between the interest rate received from the swap contract and the interest actually owed on the bonds. The College shall consider swap agreements based on either LIBOR or BMA indices. Basis risk shall be considered vis-à-vis unexpected interest cost, market termination and restructuring risks.

d. Tax risk: the risk that changes in federal income tax rates could impact the trading relationship between tax-exempt and taxable securities.

The College must be compensated for these risks and realize an appropriate premium to utilize a derivative structure versus more conventional financing. The College will be cautious of those transactions that limit future flexibility.

Pursuant to FASB 133, the College shall fully disclose: a) its interest rate swaps in the footnotes to its audited financial statements; b) the market value on June 30 of the applicable fiscal year in the Statement of Financial Position; and, c) the year-to-year change in market value in the Statement of Activities. To this end, the College shall require swap counterparties to provide written semi-annual swap valuations.

Management and the Finance & Investment Committee shall annually review outstanding swap transactions.

As a guideline, the College should consider limiting its total exposure to derivative products to no more than 67% of total outstanding indebtedness.

D. Ratings Management

The College will maintain the highest possible credit rating within the context of the College's education-related goals.[1] Neither Management nor the Finance Committee will knowingly engage

[1] The College currently has unenhanced municipal bond ratings of "A1" and "A+" from Moody's Investors Service and Standard & Poor's, respectively.

the College in a transaction that is likely to negatively impact the College's rating without first obtaining Board approval.