# PUBLIC SUPPORT FOR PRIVATE COLLEGES: SOME FINANCING OPTIONS

**Remarks of Robert Dean Pope**
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Good morning. My name is Dean Pope. I am a public finance lawyer with Hunton & Williams, having worked on bond issues in Virginia for more than 35 years. I have been asked to address the legal and practical financing options available to the Commonwealth of Virginia in assisting private colleges in Virginia to continue, improve and expand the quality education that they have provided now for several centuries, education that has benefited the Commonwealth and its citizens in countless ways.

In particular, I would like to suggest a program combining two things. The first is a form of credit enhancement from the Commonwealth based on ample and happy precedent. The second component would consist of a modest outlay for incentive grants that would in turn enhance the ability of our private colleges to do more with their own resources. This combination, I am confident, could be worth significantly more than the sum of its separate costs because it would materially lower financing costs, encourage private fundraising and create strong incentives for private colleges to do exactly what the Commonwealth and its citizens want these colleges to do — to provide quality education to more Virginians on campuses that offer safe, attractive and efficient facilities.

Let's start with the credit enhancement. I know that this Committee is familiar with the Virginia College Building Authority. The VCBA currently has the authority to issue bonds for both public and private colleges. For public colleges, VCBA issues bonds under a program that provides credit enhancement that translates into lower interest rates for the public colleges that utilize the program.

But for its issuance of bonds on behalf of private colleges, the VCBA is a pure conduit issuer. It does not provide any credit enhancement or assist in making the bonds for the colleges more marketable than they would otherwise be.

A private college using the VCBA simply gets the advantage of tax-exempt interest rates, but these rates are based solely on the creditworthiness of the college. In other words, the VCBA does not currently provide private colleges any assistance in making their bonds more marketable, therefore giving them access to lower interest rates and lower financing costs.

Importantly, however, there exist in Virginia other programs that can provide a model for a new program, probably through the VCBA, that would materially assist private colleges in accessing low cost capital. Over the last few decades, the Commonwealth has developed creative programs that permit state and local governments to obtain financing at very affordable low interest rates, substantially lower than those available to such borrowers based solely on their own credits. These savings result from the Commonwealth's decision to provide assistance, not through actual dollars, but instead through a so-called subject-to-appropriation undertaking to provide funds necessary to pay the bonds if, and only if, the basic payment sources are inadequate.

These programs permit the bonds to be sold with very high ratings ─ from the national rating agencies ─ Moody's, Standard & Poors and Fitch ─ not because of any direct state appropriation but because of undertakings by the Commonwealth that provide the necessary assurance to the market that the bonds will be paid.

I refer to these programs as Commonwealth credit enhancement programs.

The two relevant examples are the programs of the Virginia Public School Authority and the Virginia Resources Authority. In both cases high ratings ─ and therefore lower interest costs ─ are obtained, not by any direct appropriation by the Commonwealth but instead by an undertaking, again subject-to-appropriation, to appropriate money if ─ and only if ─ such appropriations in fact are ever necessary to ensure payment of the bonds.

Let me explain. In the Virginia Public School Authority example, the bonds are payable directly from the payment obligations of the underlying borrowers, localities borrowing money for local school projects. However, the high credit ratings are obtained by two provisions. These consist of (1) an intercept program, whereby state funds payable to the localities will be diverted to pay debt service if necessary, and (2) a subject-to-appropriation promise by the Commonwealth to appropriate a "sum sufficient" to make up any deficiency caused by the failure of the underlying borrowers to pay.

Obviously if there is a failure of the underlying borrowers to pay, there are economic consequences for the Commonwealth, but to date this has never happened. The low cost borrowing has been obtained without any direct outlay by the Commonwealth.

In my opinion, the most appropriate model for assisting private colleges is the Virginia Resources Authority model. The VRA issues bonds for the benefit of state and local governments to finance infrastructure, environmental, recreation and other local government capital projects.

While localities are primarily obligated to pay the debt service, VRA Bonds also are secured by a debt service reserve fund, called the Capital Reserve Fund. As permitted by federal tax regulations, this Reserve is funded with proceeds of the bonds in an amount equal to the maximum amount payable as debt service on the bonds in any year. In other words, 100% of the borrowers could stop making payments and there would still be no payment default on the bonds for at least 12 months.

If any of the underlying borrowers fails to make debt service on a timely basis, the debt service reserve fund will be drawn upon to make payment. And here is where the Commonwealth's credit enhancement comes into play. Under the VRA legislation, if VRA notifies the Governor that the reserve fund has been tapped, the Governor is obligated to request appropriation of an amount sufficient to replenish the reserve fund. Since this is an annual obligation, investors in reliance on such provision treat the bonds as secured by the Commonwealth's "subject-to-appropriation" credit and accept lower interest rates.

This subject-to-appropriation obligation of the Commonwealth also has in fact never been called on by VRA. That is important. It means that the Commonwealth has been able to produce low cost borrowing for localities <u>without actually appropriating a penny</u>.

The VRA model offers an attractive option by which the Commonwealth could assist private colleges in borrowing money at very affordable rates.

Obviously, as with the VRA program, there would be a risk that actual funds of the Commonwealth could be required. If, under such model, the private colleges did not pay debt service, the reserve fund would be hit and the Commonwealth would be called upon to appropriate the deficiency. Accordingly, if the Commonwealth were to institute such a program for private colleges, it clearly would need to impose standards that would reduce to an absolute minimum the chances that the Commonwealth's subject-to-appropriation obligation would ever be called on.

Let's stop for a moment and talk about the history of this subject-to-appropriation financing device. The Commonwealth of Virginia has used it creatively — but prudently — for several decades. There are severe limitations on the Commonwealth's ability to incur actual legal debt. General obligation debt generally can be incurred only after voter approval.

The subject-to-appropriation obligation provides an alternative. Because the General Assembly has the ultimate power to choose <u>not</u> to appropriate, a "subject-to-appropriation" obligation is not legal debt. The Virginia Supreme Court has repeatedly recognized this. The Commonwealth of course recognizes that any failure to honor its subject-to-appropriation obligation would have serious consequences for the Commonwealth, and the General Assembly has never failed to appropriate whenever required.

In this case, the Commonwealth would certainly want to create, through the Virginia College Building Authority or otherwise, appropriate standards to ensure that the private college borrowings undertaken through such program were soundly structured and the colleges borrowing the money in fact would have the resources to make payment.

The results could be striking. Private colleges would immediately see a major reduction in their borrowing costs, dramatically increasing their debt capacity and access to tax-exempt borrowing.

This is extremely important when one looks at the broader world of private higher education financing. On the one hand, you have "the haves" — the Harvards and Princetons and Stanfords. With their billions of dollars of endowment, they routinely borrow at very low interest rates to finance lots of capital improvements while concentrating their fundraising on both increasing their endowment and on funding programs, such as financial aid, that are central to their mission.

In the current environment, many small private colleges are "the have-nots." Their pressing needs for capital improvements and their limited financial resources often force them to devote most of the proceeds of fundraising directly for capital improvements. This in turn limits their creditworthiness and reduces their ability to borrow on attractive terms.

So a program like this would offer a real opportunity for a financial breakthrough for these colleges.

But I strongly urge this Committee to go beyond the mere creation of a credit enhancement and instead to consider ways in which such a structure could be combined with other programs to produce really spectacular results. The combination of a credit enhancement program with selective use of incentive grants could produce synergies that would fundamentally alter the restrictions that now hamper private colleges. Most important, it would permit them to undertake programs of precisely the type that the Commonwealth and its citizens desperately need in the current economic environment.

We all support the goal of providing quality higher education for more Virginians. We all recognize that the ability of our public institutions to increase enrollment is severely limited. And we all should recognize that in the current environment, more and more students will need financial assistance to attend colleges. I was struck to learn that Virginia's private colleges enroll a larger percentage of Pell Grant recipients and minority students than the public institutions and that nationally, the average family income of students at private colleges is less than that for our public institutions. Our private colleges are doing more than their fair share of educating Virginians of all economic levels, but they need help.

Let me throw out some concepts and ask you to think real hard on how they might be used to multiply the ability of Virginia's wonderful private colleges to meet the needs of more and more Virginians.

Let's assume that the Commonwealth creates a program of incentive grants to go with the credit enhancement program. If properly structured such a program, I am confident, would pass constitutional muster in Virginia. At least three states, Maryland, New Jersey and New York, provide capital outlay funds to private colleges and at least seven — including Alabama and Louisiana — provide operating funds.

The grants that I am proposing would be awarded based on reciprocal supporting undertakings by the benefiting colleges to carry out specific programs advancing specific goals of the General Assembly and the Commonwealth. These undertakings by the private colleges could include commitments to undertake capital projects, to devote financial resources to such purpose, to increase enrollment of Virginia students, to increase financial assistance to Virginia residents.

Let's take those in order. Grants for specific capital projects could be based on the college's willingness to borrow through the enhancement program a portion, let's assume half, of the cost of such project, combining public and private funding. This would encourage much needed capital projects at the lowest possible cost. Grants tied to matching fundraising would assist both in encouraging private philanthropy and in increasing the ability to build up credit worthiness and to fund other activities. Grants tied to increasing enrollment would directly promote the goals of the Commonwealth while assisting the colleges in building the facilities required for increased enrollment. Grants tied to increases in financial assistance obviously would benefit the Commonwealth and its citizens by permitting the colleges to devote to financial assistance the funds that otherwise might be exhausted by capital projects. And the costs of those capital projects would be reduced both by the grants themselves and by the lower financing costs for the portion of capital projects paid for directly by the colleges.

Synergies of this kind could dramatically increase the ability of private colleges to improve their facilities while meeting their public responsibilities. Obviously it would not instantly move them to the happy position of the Harvards and Princetons. It could, however, liberate many of them from the current quagmire that forces them to direct their limited resources to capital improvements they desperately need, often on unattractive terms, and therefore hampers expansion of enrollment and financial assistance and precludes the steady improvement in financial health that every institution of higher education should seek.

The private colleges of Virginia are an extraordinary resource. They have provided quality higher education to Virginians, not just years or decades, but for centuries. Few states rival the Commonwealth in terms of so many institutions of such high quality.

So I urge you to strongly recommend the creation of a credit enhancement program of the type I have described. The precedents give us guidance on how to structure it. And I strongly urge you to support a program of incentive grants that will build on the synergies of private fundraising and low cost capital.

Wealthy private colleges — the Ivy League schools and others — have over many years profited immensely in the ability to combine financing and fundraising to accomplish their educational goals.

With just a little help from the Commonwealth, the private colleges of Virginia can follow that example and produce extraordinarily important and positive results of major benefit to our citizens.