

Contents

**I. Feature:**

Backstop Action: Why LOC Structures Still Work

**II: Senior Living:**

Rediscovering FHA Financing for Senior Living

**III: Health Care:**

2008 Rural Hospital Renovation Study Report

**IV: Affordable Housing:**

Preservation for the Next Generation: Sec. 202 Refinance Success Stories

**V: The Nonprofit Minute:**

Investment Topiary: How to Cultivate a Natural Hedge

Sign Up

If you would like The Capital Issue e-mailed to you, please register at

www.lancasterpollard.com

The Nonprofit Minute

**Investment Topiary: How to Cultivate a Natural Hedge**

In unstable markets, borrowers with floating-rate debt often see increased volatility not just in their interest rate and debt service expense, but also in other aspects of the balance sheet. Given that budget items and asset values can fluctuate with the markets, it should be understood – but often isn't – that these elements also can be used to help stabilize the balance sheet.

Financial stability can, and should, be controlled from both sides of the balance sheet by cultivating an organization's natural hedges against volatility.

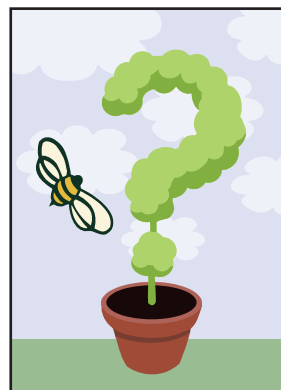
**Interest Rate Risk**

A critical component to a successful debt management plan is the net variable rate exposure, or the actual amount of unhedged debt that will contribute to higher net expenses as interest rates rise. The appropriate amount of net variable interest rate exposure depends on an organization's ability and willingness to absorb potential rate-associated risks to its revenue stream and reserve levels.

Some floating-rate borrowers choose to enter into swap agreements, in which the borrower agrees to pay out a fixed amount each month to a counterparty in exchange for receipt of a variable-rate payment that approximates the borrower's interest payment. The net result to the organization with the variable-rate debt

is more predictable cash flow and decreased variable rate exposure.

An organization should not, however, pay to swap the interest rate on all of its debt if swapping only a portion of the debt provides enough protection against interest rate fluctuations.



**Appropriate Exposure**

Standard & Poor's used to recommend that no more than 25 percent of an organization's variable-rate debt remain unhedged. The rating agency eliminated this net variable rate exposure guideline several years ago in favor of a case-by-case review that takes into account

differences among issuers in regards to liquidity and credit. In particular, reserve levels, asset and liability composition, budgeting processes and risk management policies and procedures are evaluated. The appropriate exposure ratio depends on an organization's ability and willingness to take on risk: The more conservative, the lower the ratio should be.

Investment decisions on the asset side of the balance sheet can play a crucial role in determining and managing interest rate risk exposure, as asset allocation decisions impact more than just investment returns. For organizations with variable rate debt, they also can provide specific hedging opportunities.

# The Capital Issue: The Nonprofit Minute

## The Natural Hedge

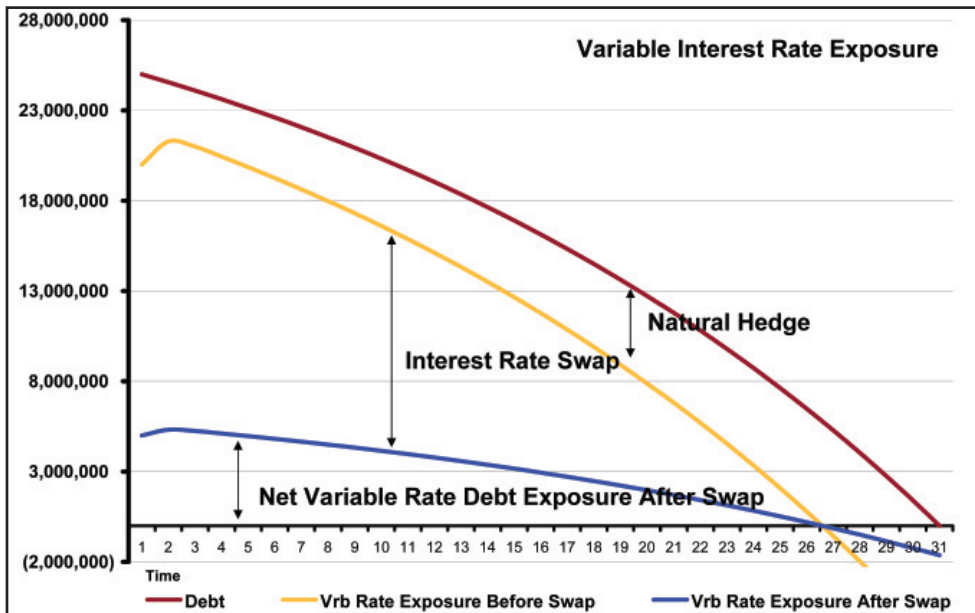
Variable-rate debt is offset by a natural hedge, when matched with cash and short-term fixed income securities. Managing these investment assets alongside variable-rate debt can reduce interest rate risk because higher interest expense is offset by higher interest earnings. Hence, the net variable rate exposure can be defined as an organization's outstanding variable rate debt, minus the offsetting floating rate investments (natural hedge), minus floating to fixed interest rate swaps.

By changing the asset allocation and the type of investments in its portfolio, an organization can impact the amount that can be considered a "natural hedge," and attain the desired net interest rate risk exposure. Typically, unrestricted, non-operating assets invested in very liquid securities such as U.S. Treasuries, government agencies, commercial paper and repurchase agreements with maturities of less than one year are considered qualifying investments for a natural hedge. Operating accounts and other invested assets that cannot be considered surplus reserve accounts are excluded from the natural hedge as the balance in those accounts can vary significantly.

## Monitoring Risks

Internal monitoring is an integral part of managing risks. The finance committee's regular review of net variable rate exposure should include a detailed review of the composition of debt and investments as well as existing and additional interest rate management opportunities. Nonprofit organizations should be sure to have a plan to maximize long-term outcomes at an acceptable risk level, and stay with it.

The exposure ratio should not only be calculated based on existing numbers, but also with projections based on any proposed derivative structures, changes to the investment portfolio or future bond issuances.



Total variable-rate debt does not equate to net interest rate risk exposure; risk exposure for most organizations is usually less than the total variable-rate debt amount.

In this example, the organization's asset allocation acts as a natural hedge: as debt service payments fluctuate with interest rates, income from investment assets should correlate. Note that the organization entered into a swap, but rightly swapped only as much debt as was necessary to achieve its target risk exposure.