The Church Network — July 15, 2015

Managing Liquidity & Financial Position for Churches

Presentation Slides and Article

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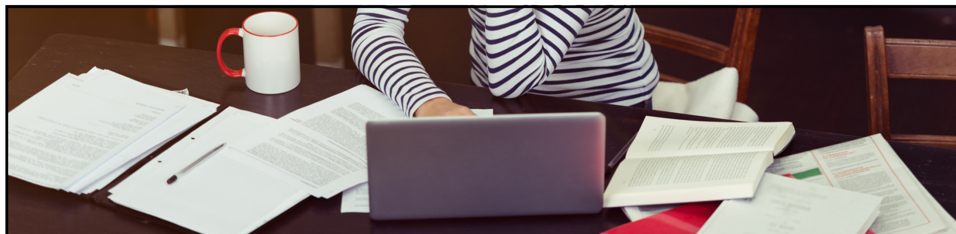

Learning Objectives

1. Know the critical starting point for liquidity and financial position management
2. Identify metrics for “sound” and “strong” financial position
3. Adopt specific strategies for implementing a successful liquidity and financial management plan

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Not all churches have the same mission and purpose

and accordingly, not all churches have the same priorities when it comes to budgeting.

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Only after defining mission and purpose well can a church begin an effective budgeting process – otherwise, how can a church know whether a proposed program, activity, or initiative is on-mission or not?

Mission-based budgeting

vs.

Good-idea-based budgeting

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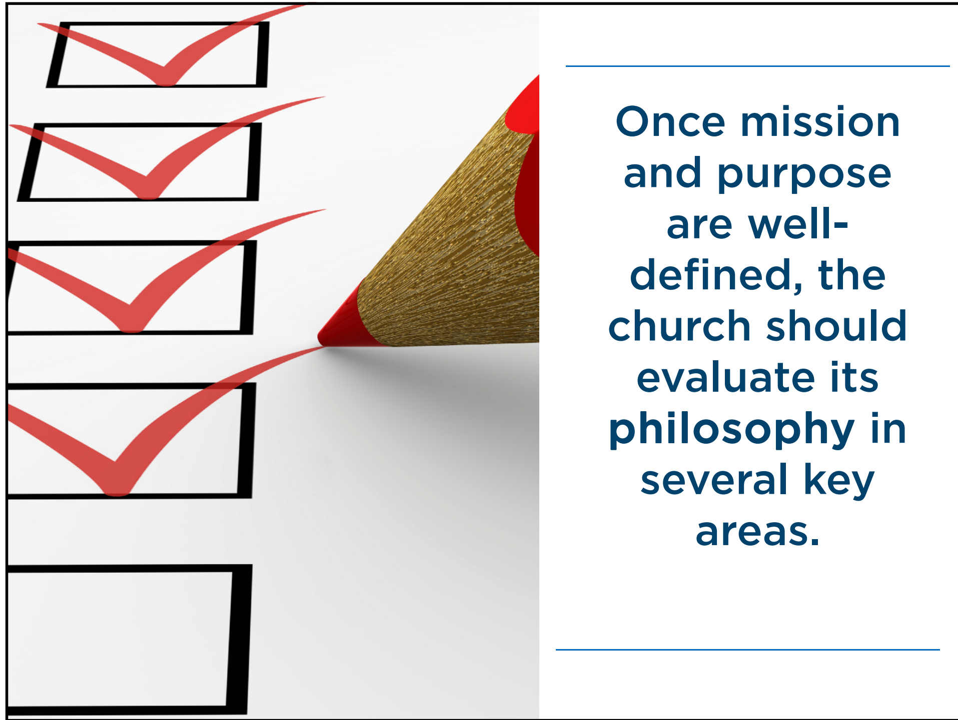

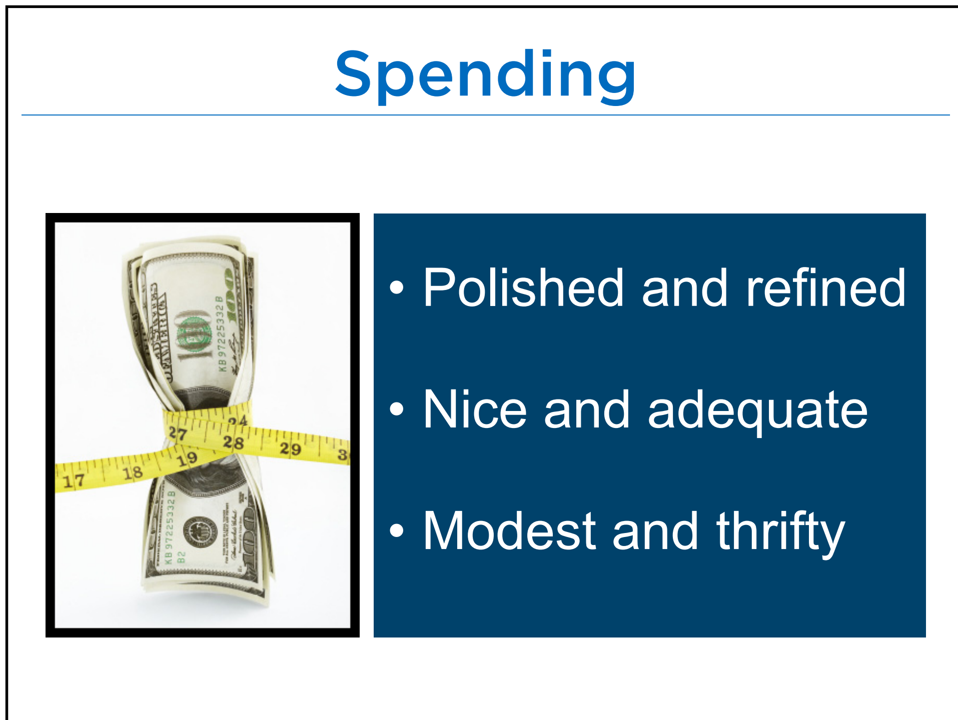

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Compensation

- Well above average
- Above average
- Average
- Below average
- Vow of poverty

Cash Reserves

- Storehouse
- Manna

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Debt

- Debt is evil and must be avoided
- Debt is a tool – like a chainsaw

Targeting and Achieving Desired Financial Position

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Recommended Liquidity and Financial Position Objectives

Operating Cash Reserves

SOUND 3 months of operating cash expenses plus current liabilities

STRONG At least 6 months of operating cash expenses plus current liabilities

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Debt Service Reserves

(For churches with mortgage or other long-term debt)

SOUND 6 months of debt service costs (principal and interest payments)

STRONG At least one year of debt service costs

(Special consideration when debt reserves are required as a term of the loan agreement)

Debt Level

SOUND Total liabilities should not exceed 2.5 times unrestricted net assets

STRONG Total liabilities are less than 2 times unrestricted net assets

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Loan-to-Value Ratio

SOUND Debt should not exceed 70% of the current market value of the underlying property

STRONG Debt is less than 65% of the current market value of the collateral property

Debt Service

SOUND Annual debt service payments (principal and interest) do not exceed 15-20% of the church's annual cash operating expenses.

STRONG Annual debt service payments do not exceed 10% of the church's annual cash operating expenses.

(Note – debt service payments funded by special gifts or separate funds, such as a building fund or debt service fund, would not be counted in this calculation.)

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Average Age of Accounts Payable Invoices

SOUND
Average should not normally exceed 25 days

STRONG
Average not more than 15 days

Investment Management

- Remember UPMIFA
- Investment Philosophy
- Investment Policy

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Two circumstances in which debt financing may be appropriate:

1. When a church needs financing to fund the acquisition, construction, improvement, or refinancing of its long-lived furniture, equipment, or facilities

Or:

2. When a church needs temporary financing to cover short-term, seasonal variations in cash flow

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When debt financing is not appropriate:

- To finance operating costs or non-capital outlays. (A working capital line of credit may be useful if cash flows are truly seasonal and funds for repayment are reasonably assured. However, an unexpected downturn or shortfall in revenue is probably the worst possible reason to incur debt financing.)

- When cash flows are not growing or at least stable. (A church should never enter into debt financing if its cash flows are declining – even if current cash flows cover the required debt service. The church must determine the reasons for the downward trend and address that satisfactorily before it should consider debt financing.)

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- When personal guarantees are required. (Requiring personal guarantees of church leaders in connection with church debt would be an extraordinary requirement in today's market. If a lender were to impose such a requirement, it is likely an indicator that either the borrower does not have satisfactory capacity to obtain a loan under ordinary market terms or the lender does not operate with an appropriate level of professionalism.)

- When the lender will not offer the church market rates and terms. (Above-market interest rates and highly restrictive terms are indicators that a lender perceives the church's credit risk as higher than normal. A higher than normal credit risk means, of course, a higher risk that the church may not be able to satisfactorily service its debt obligations.)

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Following are some comments by nationally prominent church lenders regarding the use of debt financing by churches and ministries.

"Strong, effective board oversight and leadership accountability are – by far – the greatest contributors to healthy financial choices and faithful loan performance."

Mark Holbrook
President and CEO
Evangelical Christian Credit Union

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BANK OF THE WEST

"The most common challenge a ministry encounters when it is pursuing approval of a mortgage loan is the lack of adequate recent cash flow."

Dan Mikes
National Division Manager
Religious Institution Banking - Bank of the West

Ziegler
CAPITAL :: INVESTMENTS :: ADVICE

"The most important attribute that makes a ministry a strong candidate for a mortgage loan is a need driven by growth and vision."

Scott Rolfs
Managing Director
Head of Religion Division - Ziegler Investment Banking

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A Word about Tax-Exempt Bond Financing

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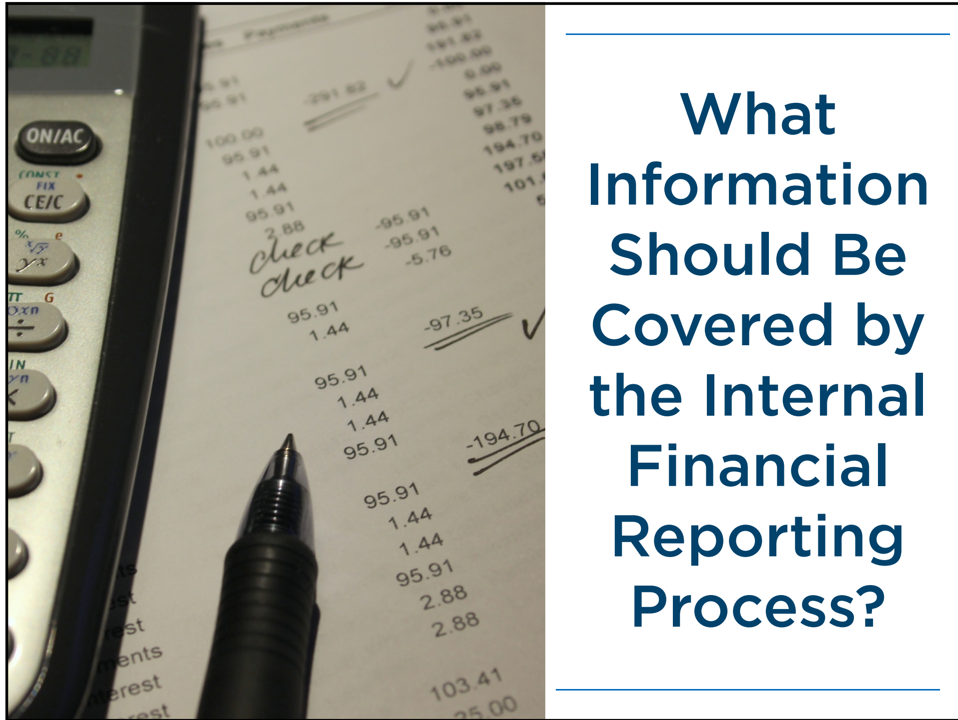

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27 Key Questions

1. Is the church's current liquidity sound or strong? How do we know?

27 Key Questions

2. Is the trending in the church's liquidity improving or declining? Elaborate.

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27 Key Questions

3. What is the church's current balance for cash and other liquid assets? What is the balance net of donor-restricted and designated amounts? Provide details.

27 Key Questions

4. If current accounts payable and other similar liabilities were paid, how many months of cash operating expenses would the current cash and liquid assets balance (net of donor-restricted and designated amounts) cover?

    a) How does the answer to this question compare to the church's objectives for this matter?

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27 Key Questions

4. b) Is there a plan in place to improve the operating cash reserves balance? What is the plan? How are we doing with respect to implementing the plan?

27 Key Questions

5. Is the church paying all of its bills on time? How do we know?

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27 Key Questions

6. Has the church had any trouble in recent weeks or months meeting its cash flow demands? If yes, elaborate.

27 Key Questions

7. Does the church expect to have any trouble in the foreseeable future with respect to meeting its cash flow demands? How do we know? If yes, elaborate.

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27 Key Questions

8. Has the church borrowed any money to fund regular operations or noncapital outlays? If yes, elaborate.

27 Key Questions

9. Has the church dipped into donor-restricted or designated cash or investment balances in order to fund operations at any point during the last year? How do we know? If yes, elaborate.

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27 Key Questions

10. What is the current balance of the church's mortgage debt?

27 Key Questions

11. Are debt payments being made in a timely manner, without any difficulty?

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27 Key Questions

12. Are there any specific financial covenants contained in the church's loan agreements that stipulate specific financial requirements the church must meet as a condition of complying with the terms of the loan? If yes, provide details with respect to the nature of each covenant as well as the church's compliance with the terms of the covenant.

27 Key Questions

13. What percentage of the church's total revenue is being spent on servicing the church's mortgage debt?
    a) How does the answer to this question compare to the church's objectives with respect to servicing debt?

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27 Key Questions

14. What is the ratio of the church's total liabilities to the church's unrestricted net assets?

    a) How does the answer to this question compare to the church's objectives with respect to this matter?

27 Key Questions

15. What is the balance of the church's debt service reserves?

    a) How many months of debt service for the church's existing mortgage debt will this balance cover?

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27 Key Questions

15. b) How does the answer to this question compare with the church's objectives with respect to this matter?

27 Key Questions

15. c) Is there a plan in place to improve the debt services reserves balance? What is the plan? How are we doing with respect to implementing the plan?

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27 Key Questions

16. Is there any other information regarding the church's overall liquidity or financial position that the church's leadership should know that the questions above do not address? If yes, provide details.

27 Key Questions

17. Is the trending with respect to overall revenue favorable or declining?

    a) If declining, what are the causes and what is the church's leadership doing to address the matter?

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27 Key Questions

17. b) Does the trending in the church's overall giving levels align with the trending in the church's overall number of active donors? Elaborate and provide details.

27 Key Questions

18. Is per capita giving trending favorably or unfavorably? Provide details.

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27 Key Questions

19. What other information about the church's revenues (especially revenues not related to contributions) is relevant to church leadership?

27 Key Questions

20. With respect to expenditures, is the church's leadership adhering to budget parameters? How do we know?

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27 Key Questions

21. Are expenditures increasing or decreasing?

27 Key Questions

22. Are appropriate approval processes in place for all expenditures? Elaborate and succinctly describe the approval process for all areas of expenditure.

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27 Key Questions

23. Is there any additional information about the church's expenditures not covered by the questions above that would be relevant to the church's leaders?

27 Key Questions

24. Is the church generating a cash flow surplus from its operating activities? Why or why not?

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27 Key Questions

25. How do the church's financial operating results compare with expectations as set forth in the approved budget?

27 Key Questions

26. Are there any current vulnerabilities, specific risks, threats, or other similar matters that could adversely affect the church's financial condition? If yes, elaborate.

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27 Key Questions

27. On a scale of 1 to 10, with 1 very weak and 10 extraordinarily strong, how would the church's leadership rate the church's current financial condition? Explain the basis for the rating.

Recap

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Determine your church's philosophy in key areas related to financial operations.

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Strive for sound or strong liquidity and financial position.

Carefully manage your investment assets pursuant a prudent statement of investment philosophy and a prudent investment policy.

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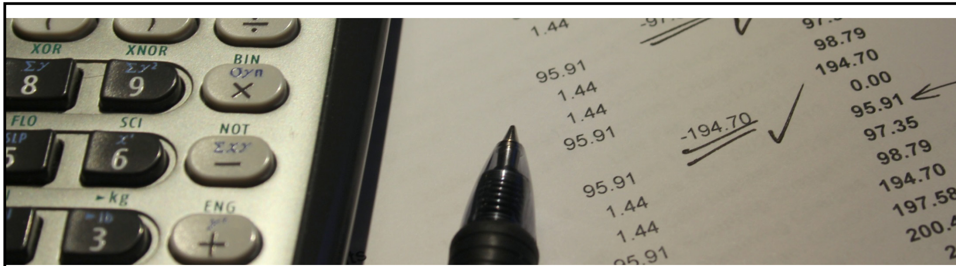

- Use and manage debt very carefully.
- Use plain-language communications to report and monitor activity.
- Thank God from whom all blessings flow.

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BAWL Batts Morrison Wales & Lee Certified Public Accountants

Managing Liquidity and Financial Position

By Michael E. Batts

Philosophy of Liquidity and Financial Position

As with budgeting, a church's management of liquidity and financial position begins with a philosophical assessment. Some churches, for example, intentionally choose to operate with little or no cash reserves because their leaders believe such a practice results in daily dependence on God to supply the church's needs. Such a philosophy is based on their view of scripture. Churches that adhere to such a philosophy often believe it is appropriate to spend all money that comes into the church soon after it arrives, to carry out the work of the church. An example of the scriptural support used by churches that follow this philosophy is God's providing for the Israelites when they were wandering in the wilderness after their exodus from Egypt. God provided daily manna from heaven and instructed the Israelites not to save any of the manna from one day to the next (other than on the day before the Sabbath), so that they would depend daily on God for their sustenance.

Other churches adhere to the philosophy that maintaining a reasonable level of cash reserves and maintaining strong liquidity is an act of biblical stewardship. Churches that adhere to this philosophy cite scriptural examples such as Joseph instructing Pharaoh to prepare for a seven-year famine by storing grain and the scriptural command in Malachi to bring the tithes into the "storehouse." Churches in this camp believe that financial stability and viability are essential traits for a church to do its work consistently and reliably. Some churches support the idea of having resources to provide for contingencies by citing the fact that David picked up "five smooth stones" for his sling on the way to see Goliath, instead of just one.

During the Great Recession that began to impact the U.S. economy so severely in late 2008, churches with little or no cash reserves felt the most immediate severe impact. In fact, many churches that had significant debt outstanding and that had little or no cash reserves found themselves in immediate financial peril. A significant number of churches were unable to pay their debt obligations and lost their church facilities in foreclosure or its equivalent. Failure to honor a debt obligation certainly presents scriptural challenges for any church leader.

While not intending to denigrate the philosophy of churches that do not maintain cash reserves, the author takes the position that it is appropriate for churches to maintain reasonable, appropriate, and healthy cash reserves and financial position. From a practical perspective, any number of unexpected developments can occur that could present cash flow challenges to a church. For example, if a well-respected leader of the church were to leave the church or were found to have committed some discreditable act, attendance and financial support of the church could be significantly and immediately impacted. A sudden downturn in the economy like that which occurred in 2008 could have a similar impact. Such an impact could be caused by the outbreak of war, a stock market collapse, or other unpredictable event.

Part of effective stewardship involves having a viable and stable ministry. If church leaders are frequently focused on addressing cash flow challenges or related concerns, they will focus less on their ministry objectives.

For churches with significant outstanding debt, the author believes that healthy cash reserves and financial position are essential in supporting the church's ability to honor its debt obligations – and that failure by a church to honor its debt obligations can adversely affect the credibility, witness, and mission of a church and its leaders. The author espouses the view that a church with the philosophy of maintaining no significant cash reserves should not incur significant debt obligations.

References to "cash reserves" herein refer not only to cash maintained in bank and similar accounts but also to investments in liquid marketable securities that may be readily converted to cash.

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Philosophy of Debt

Whether it is permissible or advisable for a church to enter into a debt obligation can also be a matter on which churches have different philosophies – often based on scripture. This article takes into consideration the reality that many churches enter into debt obligations, considering it permissible to do so, as long as the church carefully and wisely plans for the ability to honor its debt obligations. The author respects the view of some churches that they should not incur debt obligations, and the references to debt and its management herein are not intended to imply otherwise.

Philosophy of Cash Flow Surpluses

The author supports the idea that positive cash flows from the church's operations support healthy cash reserves and financial position. A church that intends to maintain a healthy financial position cannot, by definition, do so without cash flow surpluses. Many church leaders express their desire to maintain healthy cash reserves and financial position, but then operate in a manner that doesn't support that objective. If a church spends all of its cash revenue each year, that church cannot improve its liquidity or cash reserves no matter how much its leaders may say they want to.

Improving a church's liquidity and cash reserves requires intentional effort as an essential part of the planning and budgeting process. That effort must include planning to spend less than what the church receives in cash revenues. For a church that has been following the habit of spending all of its cash receipts annually, the transition can be challenging. If the church's revenues are growing, the church may be able to make progress in this area by slowing or stopping spending increases as revenues rise. For churches whose revenues are not growing significantly, the transition will require the church to pursue additional revenue (through additional giving or from alternative revenue sources), employ expense reductions, or apply a combination of the two.

If expense reductions are necessary, they may be in areas of "overhead" (administrative and supporting activities), in ministry program areas, or in a combination of the two. Churches are often very reluctant to curtail a ministry program – especially one that seems to be doing good work. It is also painful and personal when expense reductions involve employee layoffs or terminations.

The author once made the following observation to a church leader about the topic of spending discipline and liquidity:

> We all know that the church wants to do as many things as it can to carry out its mission…and that there are always more needs and more ideas for ministry than the church can carry out. Obviously, there is a limit to how much any church can spend on carrying out its mission. The absolute limit is the amount of money that comes into the church. The church will either allow that limit to be its boundary or it will choose to impose a more disciplined boundary that is within the absolute limit. Only when the church imposes the more disciplined boundary will it make progress in improving its liquidity and financial position. Either way, there will still be unmet needs and unfulfilled desires to carry out ministry.

Targeting and Achieving Desired Financial Position

While positive cash flows and surpluses have merit, pursuing them should be part of a broader but specific plan. The church should have specific, targeted objectives for achieving a desired financial condition as well as a timeframe for doing so. The combination of a specific, targeted financial position and a timeframe provides a roadmap for the church's

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leaders in planning and budgeting. Adopting specific, targeted objectives addresses the reasonable question that some may have about the church's budget surpluses…to what end is the church generating these surpluses? An appropriate response is "To achieve the church's specific objectives for liquidity and financial position."

We hear from expert financial advisors continuously that individuals should have a financial plan with specific objectives. "Get out of debt," "Build cash reserves," and other mantras are ubiquitous parts of such plans. Interestingly, churches do not commonly have specific financial objectives or a roadmap for accomplishing them.

Once the church is philosophically on board with maintaining reasonable cash reserves and improved financial position and has determined that it is willing to take the steps to achieve those objectives, the next step is to define what the church considers to be appropriate cash reserves and a desired financial condition. The church should have specific targets. For example, the church may establish that its target for cash reserves is six months of cash operating expenses. The church may also state its objective of reducing its debt from $5 million to $3 million. These are merely examples. The point is that the targets should be specific. By setting specific targets, the church knows precisely why and to what extent it is pursuing cash flow surpluses.

Once the financial position targets are defined, the church should establish what it considers to be a reasonable timeframe for achieving the objectives. For a church that is a long way from achieving its objectives, it is wise not to attempt to get from "Point A" to "Point B" overnight. Depending on the circumstances, the process of reaching the church's targets may take a number of years. If the church believes its journey from Point A to Point B will be long-term, it is important for the church to establish annual benchmarks or milestones (interim targets) to facilitate the monitoring and assessment of progress.

> For example, assume the church has one month's cash operating expenses as a cash reserve and it plans to achieve a six-month reserve. Assume the church decides to achieve its target over a five-year period, by increasing the reserve by one month's operating expenses each year. The church establishes milestones for the end of each year accordingly. At the end of Year 1, the church should have two months of operating expenses in its cash reserves. At the end of Year 2, it should have three months, and so on, until the end of Year 5, at which it should have six months of operating expenses in reserves, assuming the church has been able to follow its plan.

Recommended Liquidity and Financial Position Objectives

Church leaders may desire to improve their financial position and liquidity and to establish appropriate targets, but they may not have a sense for what the targets should be. What constitutes "reasonable" cash reserves and "sound" financial position?

Based on professional experience and on communications with other financial professionals, the author provides the following observations and recommendations. The recommendations provided herein are general in nature and may not be appropriate for some churches, depending on the individual facts and circumstances. The author recommends that each church obtain counsel from advisors with significant professional financial experience in establishing their individual targets and objectives.

Sound *refers to a level that represents the minimum position for establishing healthy liquidity and financial position.* ***Strong*** *refers to a level where financial position and liquidity should be more than adequate in most circumstances.* The term "cash" as it relates to reserves and balances is intended to include liquid marketable investment securities.

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Operating Cash Reserves

(Note – The recommended levels are based on the assumption that the church already maintains cash, including liquid marketable securities, adequate to cover all donor-restricted and designated net assets. Recommended reserves and balances are levels in excess of the amounts required to cover such items.)

Sound: Three months of operating cash expenses plus current liabilities

Strong: At least six months of operating cash expenses plus current liabilities

Debt Service Reserves (for churches with mortgage or other long-term debt)

Sound: Six months of debt service costs (principal and interest payments)

Strong: At least one year of debt service costs

(Note – If a lender requires maintenance of minimum debt service reserves, the actual use of the lender-required reserves will typically create an event of default on the loan if the use of the funds causes the reserve balance to decrease below the required minimum. Accordingly, the church should maintain debt service reserves above and beyond the level required by a lender if the church wishes to be able to use the funds without defaulting on the loan. See below for more information about debt service reserves.)

Debt Level

Sound: Total liabilities should not exceed 2.5 times the church's unrestricted net assets.

Strong: Total liabilities are less than 2 times the church's unrestricted net assets.

Loan to Value Ratio

Sound: Debt should not exceed 70 percent of the current market value of the underlying property that collateralizes it.

Strong: Debt is less than 65 percent of the current market value of the collateral property.

Debt Service

Sound: Annual debt service payments (principal and interest) do not exceed 15-20 percent of the church's annual cash operating expenses.*

Strong: Annual debt service payments do not exceed 10 percent of the church's annual cash operating expenses.*

*To the extent that debt service payments are made from operating expenses. Debt service payments funded by special gifts or separate funds, such as a building fund or debt service fund, would not be counted in this calculation.

Average Age of Accounts Payable Invoices

Sound: Accounts payable invoices should not generally be more than 30 days old if the church is paying its bills in a timely manner. Accordingly, the average age of accounts payable invoices should not exceed about 25 days. If the average age of accounts payable invoices increases much beyond 25 days, the church's leadership should consider that a warning sign of potential cash flow issues.

Strong: The average age of accounts payable invoices is not more than 15 days.

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Other Benchmarks, Ratios, Industry Data, Etc.

The author considers the benchmarks described above to be among the most important for churches to monitor and pursue for sound liquidity and financial position. Churches may find other measurements useful in their financial and other operations. In some cases, comparisons of a church's data with industry data may be useful, such as when comparing the church's salaries for key positions to information in salary surveys such as the *Compensation Handbook* published by Christianity Today. In other cases, industry data may have limited usefulness, since churches are as unique as the individuals who comprise them. For example, it might be interesting to know how a particular church stacks up against a peer group in the area of missions expense as a percentage of the operating budget or annual giving per family. However, individual churches have widely varying philosophies about such matters as missions spending and the socioeconomic demographics of a particular church will have a dramatic effect on per family giving.

Even if the peer group to which a church compares itself is extraordinarily homogeneous, the fact that a group of churches, for example, spends 4 percent on average of its budget on missions means just that. It doesn't necessarily mean that such a spending level is appropriate for a particular church. Such a determination would be based on the philosophy, mission, and objectives of the particular church. The same can even be said about broad areas such as personnel expense as a percentage of operating expenses. While churches generally tend to spend between 40 and 50 percent of their budgets on personnel, individual practices and philosophies vary widely. Some churches, for example, believe in engaging volunteers heavily and others espouse the approach of employing people to carry out most duties.

Accordingly, a church interested in tracking financial measurements and benchmarks may find the most useful information by comparing the church's own numbers over time. For example, a church may find it valuable to track the percentage of its operating expenses spent on missions over a several-year period. Similarly, a church may find it helpful to track the cost of personnel expenses as a percentage of its budget from year-to-year in order to determine whether the percentage is trending higher or lower.

Whatever methods or measurements are employed, church leaders should assess the tools and benchmarks that will be most relevant and helpful given their church's unique identity.

Investment Management

Churches that maintain cash reserves sometimes choose to invest in marketable securities in order to pursue increased returns on their investments, especially given the low interest rates that are often paid by banks on deposit accounts. Churches that maintain investment portfolios must take care to invest prudently.

At the time this article was written, every state in the United States except Pennsylvania had adopted a version of the Uniform Prudent Management of Institutional Funds Act (UPMIFA), a model law developed by the Uniform Law Commission. UPMIFA establishes legal requirements for nonprofit organizations, including churches in most states, related to the investment and management of "institutional funds." The term "institutional funds" is defined very broadly and, for all practical purposes, includes virtually all cash and investments maintained by a church or other nonprofit organization.

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The Uniform Prudent Management of Institutional Funds Act

Following is a summary of UPMIFA and its history as provided by the Uniform Law Commission[1]:

At its annual meeting in July 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and recommended it for enactment by the legislatures of the various states. UPMIFA is designed to replace the existing Uniform Management of Institutional Funds Act (UMIFA), which was approved by NCCUSL in 1972 and has since been enacted in 47 states. UMIFA was a pioneering statute, providing uniform and fundamental rules for the investment of funds held by charitable institutions and the expenditure of funds donated as "endowments" to those institutions. Those rules supported two general principles: 1) that assets would be invested prudently in diversified investments that sought growth as well as income, and 2) that appreciation of assets could prudently be spent for the purposes of any endowment fund held by a charitable institution. These two principles have been the twin lodestars of asset management for endowments since UMIFA became the law of the land in nearly all U.S. jurisdictions.

UPMIFA continues these fundamental principles as a needed upgrade of UMIFA. Both investment in assets and expenditure for charitable purposes have grown exponentially in the 35 years since UMIFA was drafted; asset management theory and practice have also advanced. UPMIFA, as an up-date and successor to UMIFA, establishes an even sounder and more unified basis for charitable fund management than UMIFA has done.

INVESTMENT

In 1972, UMIFA represented a revolutionary advance over prevailing practices which imposed upon endowments the limited investment opportunities available for managing trust assets – even endowments not organized as trusts. By stating the first prudent investor rule in statutory law, UMIFA allowed endowments to invest in any kind of assets, to pool endowment funds for investment purposes, and to delegate investment management to other persons (e.g., professional investment advisors), as long as the governing board of the charitable institution exercised ordinary business care and prudence in making these decisions. A range of factors guided the exercise of prudence.

UPMIFA incorporates the experience gained in the last 35 years under UMIFA by providing even stronger guidance for investment management and enumerating a more exact set of rules for investing in a prudent manner. It requires investment "in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances." It requires prudence in incurring investment costs, authorizing "only costs that are appropriate and reasonable." Factors to be considered in investing are expanded to include, for example, the effects of inflation. UPMIFA emphasizes that investment decisions must be made in relation to the overall resources of the institution and its charitable purposes. No investment decision may be made in isolation, but must be made in light of the fund's entire portfolio, and as a part of an investment strategy "having risk and return objectives reasonably suited to the fund and to the institution." A charitable institution must diversify assets as an affirmative obligation unless "special circumstances" dictate otherwise. Assets must be reviewed within a reasonable time after they come into the possession of the institution in order to conform them to the investment strategy and objectives of the fund. Investment experts, whether in-house or hired for the purpose, are held to a standard of care consistent with that expertise.

UMIFA initiated the era of modern portfolio management for charitable institutions. UPMIFA provides the standards and guidelines that subsequent experience tells us are the most appropriate for the purpose. Charitable institutions will have more precise standards to guide them. Courts will have more precise standards with which to measure prudence in the event of a challenge. The result should be more money for programs supported by charitable funds, including endowments.

[1] See www.tinyurl.com/UPMIFASummary

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EXPENDITURE

UMIFA initiated the concept of total return expenditure of endowment assets for charitable program purposes, expressly permitting prudent expenditure of both appreciation and income and replacing the old trust law concept that only income (e.g., interest and dividends) could be spent. Thus, asset growth and income could be appropriated for program purposes, subject to the rule that a fund could not be spent below "historic dollar value."

UPMIFA builds upon UMIFA's rule on appreciation, but it eliminates the concept of "historic dollar value." UPMIFA, instead, provides better guidance on prudence and makes the need for a floor on spending unnecessary. UPMIFA states that the institution "may appropriate for expenditure or accumulate so much of an endowment fund as the institution determines to be prudent for the uses, benefits, purposes and duration for which the endowment fund is established." Seven criteria guide the institution in its yearly expenditure decisions: "1) duration and preservation of the endowment fund; 2) the purposes of the institution and the endowment fund; 3) general economic conditions; 4) effect of inflation or deflation; 5) the expected total return from income and the appreciation of investments; 6) other resources of the institution; and, 7) the investment policy of the institution." These standards mirror the standards that apply to investment decision-making, thus unifying both investment and expenditure decisions more concretely.

UPMIFA includes an optional provision that allows states to enact another kind of safeguard against excessive expenditure. If a state does not want to rely solely upon the rule of prudence provided in UPMIFA, the state may adopt a provision that creates a rebuttable presumption of imprudence if an institution expends an amount greater than 7 percent of fair market value of a fund, calculated in an averaging formula over three years. While the 7 percent rule is likely not to be necessary, it is available for those states that may be uncomfortable with the general standards.

RELEASE OR MODIFICATION OF RESTRICTIONS

UPMIFA recognizes and protects donor intent more broadly than UMIFA did, in part by providing a more comprehensive treatment of the modification of restrictions on charitable funds. Sometimes a restriction imposed by a donor becomes impracticable or wasteful or may impair the management of a fund. The donor may consent to release the restriction, if the donor is still alive and able to do so, but if the donor is not available the charity can ask for court approval of a modification of the restriction. The trust law doctrines of cy pres (modifying a purpose restriction) and deviation (modifying a management restriction) probably already apply to charitable funds held by nonprofit corporations. UPMIFA makes this clear. Under UMIFA, the only option with respect to a restriction was release of the restriction. UPMIFA instead authorizes a modification that a court determines to be in accordance with the donor's probable intention. If the charity asks for court approval of a modification, the charity must notify the state's chief charitable regulator, and the regulator may participate in the proceeding.

UPMIFA adds a new provision that allows a charity to modify a restriction on a small (less than $25,000) and old (over 20 years old) fund without going to court. If a restriction has become impracticable or wasteful, the charity may notify the state charitable regulator, wait 60 days, and then, unless the regulator objects, modify the restriction in a manner consistent with the charitable purposes expressed in any documents that were part of the original gift.

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CONCLUSION

UPMIFA reflects and incorporates the 35 years of experience that has accumulated under the original UMIFA. Rather than changing institutional investment or expenditure practices, it brings them up to date and unifies them across a broad range of charitable funds. The better charitable institutions manage investments and prudently control expenditures, the more money they should have for program purposes.

Note that each state which has enacted a version of UPMIFA may have modified or adapted the model law in ways that are unique to that state. Accordingly, when evaluating the provisions of UPMIFA for a church in a particular state, the church should consult that state's specific laws. The model version of UPMIFA includes the following general requirements, which are generally consistent among the states that have adopted UPMIFA, for the investment and management of any institutional fund:

(1) In managing and investing an institutional fund, the following factors, if relevant, must be considered:

(A) General economic conditions;
(B) The possible effect of inflation or deflation;
(C) The expected tax consequences, if any, of investment decisions or strategies;
(D) The role that each investment or course of action plays within the overall investment portfolio of the fund;
(E) The expected total return from income and the appreciation of investments;
(F) Other resources of the institution;
(G) The needs of the institution and the fund to make distributions and to preserve capital; and
(H) An asset's special relationship or special value, if any, to the charitable purposes of the institution.

(2) Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy, having risk and return objectives reasonably suited to the fund and to the institution.

(3) Except as otherwise provided by law other than this [act], an institution may invest in any kind of property or type of investment consistent with this section.

(4) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.

(5) Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio in order to bring the institutional fund into compliance with the purposes, terms, and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of this [act].

(6) A person that has special skills or expertise, or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing institutional funds.

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Investment Philosophy

Before a church decides on the specific investments to be included in its portfolio, the church's leadership must first agree on a philosophy with respect to the church's investing activities. A church's investment philosophy should be expressed in general terms, should be in writing, and should be officially approved by the church's governing body.

In adopting an investment philosophy, the church's primary considerations are its investment objectives and its risk tolerance. For example, church leaders may express their desire for moderate growth and income potential together with low volatility and low risk of significant decreases in value. It is important for church leaders to clearly articulate their investment objectives and risk tolerance and to arrive at a clear consensus regarding these matters.

Investment Policy

Once the church's leaders have adopted an appropriate statement reflecting its investment philosophy, the church should adopt a more specific document that describes in more detail the nature of the investments to be held by the church and the allocation of the church's investment assets to particular categories of investments. Such a document is commonly referred to as an investment policy. Unless the church has leaders with significant investment expertise participating directly in the process, the church may wish to engage the services of an investment advisor or consultant in developing an appropriate investment policy. The investment policy should conform to the objectives and risk tolerance expressed by the church in its investment philosophy statement described above. The investment policy will apply the principles from the investment philosophy statement to specific assets – commonly, in the form of asset allocation parameters. For example, an investment policy statement may dictate the percentage of the church's investment portfolio to be invested in asset categories such as growth equities, value equities, government debt securities, corporate debt securities, real estate securities, commodities, international investments, etc. It is also common for investment policy statements to provide more specificity in each of these categories. For example, the policy may provide for specific levels of investment in short-term, intermediate-term, and long-term debt securities. Once an investment policy is drafted, it should be approved by the church's governing body to ensure consistency with the church's investment objectives and risk tolerance.

In addition to addressing the matters described in the preceding paragraph, the church's investment policy should also include provisions designed to remind those responsible for the church's investments of the requirements of applicable law, such as UPMIFA. Accordingly, some churches include certain UPMIFA requirements in their investment policy document - a practice recommended by the author. Additionally, the church's investment policy document should be reviewed and approved by the church's legal counsel before it is adopted in its final form.

Asset Management

A church must decide how it will manage and oversee the investment process. Some churches form an investment committee to oversee the process. Others delegate the responsibility to a finance committee or its equivalent. Some churches have their governing body (or board) oversee the process directly. If a church utilizes a committee to oversee the investment process, the committee's charter should clearly state the committee's role and reporting responsibilities. Regardless of whether a committee is used or not, the church's governing body (or board) should maintain an appropriate awareness and exercise appropriate oversight of the process.

The process of managing the individual investments maintained by a church in its portfolio requires significant and continuous attention in order to ensure that the portfolio is managed in conformity with applicable laws and in conformity with the church's investment philosophy and investment policy. If the church's investment policy requires investments to be allocated among various asset categories, the management process also includes ensuring that the portfolio is "rebalanced" from time to time to conform to the asset allocation model adopted in the investment policy.

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Because of the legal implications and related risks associated with asset management, most churches with significant investment portfolios engage external professional investment managers to oversee and manage their investment portfolios. Most churches do not have the expertise or capacity in-house to manage a significant investment portfolio in conformity with applicable laws, well-developed statements of investment philosophy, and investment policy. For particularly large investment portfolios, a church may wish to engage the services of more than one investment manager. Such an approach not only diversifies risk with respect to the investment management process but also creates an opportunity to evaluate the performance of each manager against that of the other.

When using an external investment manager, it is important for the church to periodically evaluate the manager's performance. One of the most effective ways of evaluating an investment manager's performance is to compare the total return of the individual investments with appropriate benchmarks for investment returns in the applicable categories of investment. For example, the parties may agree that an appropriate benchmark for evaluating the church's investment in domestic growth equity securities is the S&P 500 index. The benchmarks should be agreed upon in advance between the church's leaders and the investment manager, and results should be evaluated periodically. Given modern technology for investment performance reporting, such an analysis is typically available on a monthly basis along with regular investment performance reports.

Use and Management of Debt

Debt financing is like a chainsaw. It can be a very useful tool in specific circumstances, but it can also cause lethal injury if used unwisely. In the church arena, there are circumstances in which the use of debt financing can be helpful and wise, and there are circumstances in which the use of debt financing is inappropriate and dangerous.

There are generally two circumstances in which the use of debt financing by a church may be appropriate. One is when a church needs financing to fund the acquisition, construction, improvement, or refinancing of its long-lived furniture, equipment, or facilities. The other is when a church needs temporary financing to cover short-term, seasonal variations in cash flow. Even in these two circumstances, the specific conditions must be appropriate for debt financing.

There are many circumstances in which the use of debt financing by a church is unwise, inappropriate, and dangerous. It is **not** appropriate to use debt financing in the following circumstances:

- To finance operating costs or non-capital outlays. (A working capital line of credit may be useful if cash flows are truly seasonal and funds for repayment are reasonably assured. However, an unexpected downturn or shortfall in revenue is probably the worst possible reason to incur debt financing.)

- When cash flows are not growing or at least stable. (A church should never enter into debt financing if its cash flows are declining – even if current cash flows cover the required debt service. The church must determine the reasons for the downward trend and address that satisfactorily before it should consider debt financing.)

- When personal guarantees are required. (Requiring personal guarantees of church leaders in connection with church debt would be an extraordinary requirement in today's market. If a lender were to impose such a requirement, it is likely an indicator that either the borrower does not have satisfactory capacity to obtain a loan under ordinary market terms or the lender does not operate with an appropriate level of professionalism.)

- When the lender will not offer the church market rates and terms. (Above-market interest rates and highly restrictive terms are indicators that a lender perceives the church's credit risk as higher than normal. A higher than normal credit risk means, of course, a higher risk that the church may not be able to satisfactorily service its debt obligations.)

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Following are some comments by nationally prominent church lenders regarding the use of debt financing by churches:

> *Strong, effective board oversight and leadership accountability are – by far – the greatest contributors to healthy financial choices and faithful loan performance.*
>
> Mark Holbrook
> President and CEO
> Evangelical Christian Credit Union

> *The most common challenge a church encounters when it is pursuing approval of a mortgage loan is the lack of adequate recent cash flow.*
>
> Dan Mikes
> National Division Manager
> Religious Institution Banking
> Bank of the West

> *The most important attribute that makes a church a strong candidate for a mortgage loan is a need driven by growth and vision.*
>
> Scott Rolfs
> Managing Director
> Head of Religion Division
> Ziegler Investment Banking

Working Capital Loans

Churches with highly seasonal variations in cash flow sometimes utilize working capital loans to bridge the temporary gaps in cash flow in order to maintain stable financial operations. Working capital loans are often made in the form of lines of credit, which allow the church to draw and repay amounts with flexibility within the maximum limit approved by the bank. Working capital loans are typically made by lenders only to the most creditworthy borrowers, and only in scenarios where there is a history of seasonal or cyclical cash flows creating reasonable assurance that the amounts borrowed will be repaid in the future. As mentioned previously, working capital loans should never be utilized to fund unexpected downturns in revenue or operating expense shortfalls unless the church has specific and reliable reasons to believe that near-term cash flows will be adequate to allow the church to repay the debt.

Working capital loans may have specific maturity dates or, in some cases, they are due "on demand," which means that the bank may require repayment at its demand at any time. Working capital loans typically require minimum payments equal to the monthly interest charge on the outstanding balance. Principal payments are typically flexible until maturity. In some cases, lenders will require that a working capital line of credit be paid down to a zero balance for a minimum period of time at least once annually.

Furniture and Equipment Financing

Churches sometimes use debt financing to acquire furniture and equipment with long-term lives. Examples may include a major audio system for the church, a new air-conditioning system, new sanctuary seating, vehicles, etc. Furniture and equipment loans are typically term loans with fixed interest rates and fixed payments that amortize the loan over a period of three to seven years. In evaluating whether to utilize debt financing to acquire such assets, a church should consider whether it has alternative means for funding the acquisition of those assets and whether it has adequate cash flows to service the payments that will be required by the new financing. If a church has a stable history of generating cash flows which are more than adequate to service such debt, the use of furniture and equipment financing may be appropriate.

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Mortgage Financing

The most significant type of debt financing utilized by churches in the United States is mortgage financing incurred for the purpose of acquiring, constructing, improving, or refinancing church facilities. When it comes to mortgage financing, lending professionals generally agree that the best candidates for borrowing are those churches who need the financing to support larger facilities or new facilities driven by the church's growth. The need to provide for growth is arguably the "healthiest" reason a church may pursue new mortgage debt. In addition to borrowing to support growth-driven expansion, borrowing to refinance existing debt to achieve more favorable terms (especially a lower interest rate) can also be a healthy reason for a church to pursue a new mortgage. (However, refinancing for the purpose of extending and reducing payments is often not a healthy scenario.)

The Four or Five C's of Credit in Church Mortgage Financing

Lending institutions often refer to "the Four C's of Credit." Interestingly, while there is some commonality among those who cite the Four C's, different institutions cite different "C's," and some refer to five rather than four. The C's most commonly cited are: Character, Capacity, and Collateral.

Based on professional experience and communications with numerous church lenders over the years, the author hereby advances ***The 5 C's of Church Mortgage Financing*** as follows:

> **Character**. The integrity and acumen of the church's leaders, and the quality of the church's accounting books and records. Character also includes the quality of the church's governing body (board) and the manner in which the governing body exercises oversight with respect to the church's activities.
>
> **Cash Flow.** A stable history of positive cash flow which clearly supports, in a well-documented manner, the church's ability to honor the proposed debt obligations.
>
> **Cash Reserves**. Cash and investment balances sufficiently significant to provide the church with flexibility and time to adapt in the event that the church experiences unexpected difficulty in servicing the debt from regular operating cash flows.
>
> **Collateral**. Assets underlying the debt which have a market value significantly in excess of the debt amount and which are pledged to satisfy the debt in the event that the church is unable to repay.
>
> **Contingency Plan**. A plan that church leaders develop in advance addressing how it will adapt to ensure the church's ability to honor its debt obligations in the event of a sudden or unexpected downturn in revenue or other financial challenge.

Let's take a look at each of these Five C's in more detail.

Character

The starting point for a borrowing and lending relationship between a church and a financial institution is trust. The lender must believe that the church's leaders are people of integrity; that they are capable leaders; that they have an adequate command of their church's operations and financial condition; that the church's books and records are adequate, timely, and reliable; and that the church has a genuine intent and ability to honor the terms of any proposed debt agreement.

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Additionally, the lender must have a sense that the church is well-governed. The governing body (board) of the church has a legal, fiduciary duty to exercise due care and prudence in the oversight of the church's activities – both financial and operational. Character in this context involves healthy, rigorous, and proactive engagement by the church's governing body to ensure that the church and its leaders operate within well-developed policies and parameters and that it stays "on mission" with respect to its activities. These responsibilities of the governing body must be carried out with appropriate independence and without improper conflicts of interest.

While it may seem that addressing the topic of character and integrity in the context of church leadership may be unnecessary, unfortunately that is not the case. Churches and ministries in America have experienced numerous high-profile examples of failed integrity and morality by those who lead them. In March of 2015, Dan Busby, president of ECFA, released a new book on the topic of integrity for church and ministry leaders, entitled ***Trust: The Firm Foundation for Kingdom Fruitfulness****.* The author highly recommends that church leaders consider Mr. Busby's commentary on the topic.

Cash Flow

When considering a mortgage loan, a lender is looking for documented history of the church's ability to make the proposed debt payments, not a commitment from the church that it will raise revenues or decrease expenses in the future in order to be able to make the payments. In making that assessment, lenders typically calculate a ratio commonly referred to as the "debt service coverage ratio (DSCR)." While lenders most assuredly assess the church's DSCR in the loan approval process, the church may not realize how this method of cash flow assessment is calculated. The DSCR is typically calculated as follows:

Most recent year's change in unrestricted net assets + depreciation expense + interest expense
Divided by
Next year's required debt payments (principal and interest)

(Some variations in the details of the DSCR calculation vary from lender to lender and from church to church, based on specific facts and circumstances.)

The idea behind this ratio is to determine whether the cash available from operations is adequate to make the proposed debt payments. Some lenders will accept a DSCR as low as approximately 1.1. However, many lenders require a DSCR of 1.25 or higher. In the opinion of the author, a healthy DSCR will be at least 1.25 and a strong DSCR will significantly exceed 1.25. Some lenders will stipulate as a requirement of the loan agreement that a minimum DSCR be maintained in each year that the loan is in place.

Cash Reserves (for Debt Service)

The author suggests that a church with long-term mortgage debt should maintain healthy operating cash reserves as well as a cash debt service reserve equal to at least six months of required debt payments (principal and interest). The church will maintain a stronger financial position by having a debt service reserve equal to at least one year of required debt payments. The larger the church's debt service reserve balance, the more time the church will have in the event of an unexpected downturn in revenue or other financial challenge to adapt to the situation while still being able to make the required debt payments.

Some lenders will stipulate as a condition of making a mortgage loan that a church maintain a minimum balance in a cash debt service reserve account at all times while the loan is outstanding. While such a requirement of the lender may seem to have the advantage of forcing the church to maintain a debt service reserve as described in the preceding paragraph, when the debt service reserve requirement is a contractual part of the loan, the concept is a bit more complicated.

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When a church maintains a debt service reserve on its own volition (without a contractual requirement), the church can actually use a portion of the debt service reserve if necessary to maintain consistent operating cash flows. However, when the debt service reserve is contractual, the church cannot spend the reserve balance below the required minimum without triggering an event of default under the terms of the loan. For this reason, if a church has a contractually required minimum debt service reserve as part of its loan terms, the church should maintain an additional debt service reserve above and beyond the contractual minimum in order to ensure that the church has funds that it can actually use in the event that they are needed without triggering an event of default under the terms of the loan.

A Special Word about the Importance of Cash Reserves for Debt Service

A church that is building or acquiring new property using debt financing typically puts significant cash equity into the property to reduce the amount of debt needed and to establish an appropriate loan-to-value ratio. While having substantial equity in its real estate is an advantage, in the opinion of the author, maintaining an adequate debt service reserve is a higher priority than increasing equity in the real estate. In other words, it may be more advantageous to put less cash equity into a property in order to maintain an adequate cash reserve for debt service, assuming that the resulting loan-to-value ratio is appropriate. An adequate debt service reserve can provide much-needed flexibility and can assist in continuing to make debt payments in the event of an unexpected adverse financial development. Equity in the property does not offer this advantage.

Collateral

Church mortgage lenders typically require collateral in the form of the church's real estate as a condition of making a real estate-related loan. Commonly, lenders require that the loan amount not exceed 70 percent of the market value of the real estate that collateralizes the loan. There are occasional exceptions. In some cases, lenders require the loan-to-value ratio to be even lower than 70 percent. The loan-to-value ratio measurement is typically made at the beginning of the loan relationship and is not typically re-evaluated during the term of the loan unless there are unusual circumstances. An independent appraisal of the church's real estate is typically required to corroborate the value of the property.

Regardless of whether a lender requires a maximum loan-to-value ratio, a borrowing church should avoid entering into a loan relationship where there is not adequate collateral to satisfy payment of the loan in the event that the church is unable to pay. In the event a church is unable to make its required debt payments and no other solution is available, the lender may be required to foreclose on the church's property. While foreclosure on a church's property is certainly an unfortunate event, the situation is made worse when the proceeds from foreclosure do not adequately cover the balance owed by the church to the bank. In such cases, a lender may pursue the church's other assets to make up the deficiency.

Contingency Plan

Church leaders should develop a plan in advance addressing how it will adapt to ensure the church's ability to honor its debt obligations in the event of a sudden or unexpected downturn in revenue or other financial challenge. While no one enjoys thinking about what bad things can happen, prudence dictates that it is wise to prepare for unexpected developments and to have a plan. Suppose, for example, that a high-profile church learns that its popular pastor has been engaged in moral misconduct and is then terminated from his position. Such a church may experience a significant decline in attendance and financial giving. If the church has significant mortgage debt outstanding, such a development can create immediate and significant financial challenges. The church will need to adapt by reducing expenses and possibly in other ways. Unexpected developments can certainly come in forms other than the moral failure of a church's leader. Other possibilities include the sudden and unexpected death or disability of the church's pastor; an act of misconduct by a person serving the church involving a child, a counselee, or another person; etc.

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A church's contingency plan in this context need not be particularly detailed. It can be a helpful exercise to simply develop a list (in order of priority) of the expenses that would be cut in the event of a significant unexpected development that adversely impacts the church's revenue stream.

One type of unexpected negative development for which the church can usually insure the risk is the unexpected death or disability of the church's senior pastor or any other leader whose death or disability could result in a significant downturn in the church's revenues. Insurance providing this type of coverage is commonly referred to as "key-man" insurance. Key-man life insurance is readily available (and typically, at a fairly reasonable cost) in the marketplace, assuming that the church leader is in good health and is otherwise insurable. Key-man disability insurance provides coverage in the event that the church leader is no longer able to perform his or her customary services for the church. Disability insurance coverage may be available in the form of a lump-sum payment or a stream of monthly or annual payments. Availability and cost of disability insurance varies significantly. However, key-man disability insurance is typically significantly more expensive than key-man life insurance. Insurance professionals often cite statistics stating that a person is more likely to become disabled early in life than to die. Church leaders should take these factors into consideration if they have significant mortgage debt and if the church's revenue stream could be significantly adversely impacted by the unexpected death or disability of one or more of the church's leaders. In some cases, lenders will require a church to maintain key-man life insurance in a particular minimum amount during the term of a mortgage loan. In rare cases, the lender may require a church to submit a leadership succession plan.

Mortgage Debt Options and Terms

Church mortgages come in many varieties. In some cases, a church may have the opportunity to choose from among various options made available by the lender. Following is a discussion of some of the more significant options and terms that are commonly addressed in the church mortgage lending process.

Fixed or Variable?

Long-term fixed rate church mortgages are a very rare breed in the bank lending marketplace – for all practical purposes, they are extinct. If a church is part of a denomination that has a denominational church lending organization, that denominational lending organization may offer longer-term fixed rate church mortgages to churches within the denomination. Churches that do not have such an option and are interested in a true long-term fixed rate mortgage may wish to consider bond financing as an alternative to bank debt. Bond financing is addressed in more detail below. However, banks and other traditional lenders will often offer a church the option of a loan with a variable interest rate or a loan with an interest rate that is fixed for a period commonly ranging from three to five years (the actual number of years in this range for which a lender will fix the rate varies by lender and by scenario). Banks and other traditional lenders very rarely offer fixed interest rates for periods in excess of five years, but it does happen on occasion. For short-term fixed-rate loans, the loans typically either mature at the end of the fixed-rate term or they "reprice," meaning that a new interest rate is set at that time based on current market rates. A fairly common arrangement is a 10-year loan with an interest rate that is fixed for the first five years and is then adjusted to a new fixed rate (based on market conditions at that time) that applies to the second five-year period of the loan.

In deciding whether a variable rate is appropriate for a particular church, church leaders should assess their appetite for interest rate risk as well as their perception about the future of interest rates. In the years since the Great Recession began in late 2008, the vast majority of borrowers who have made assumptions about future interest rates have been wrong in their assumptions. Nonetheless, a loan with a variable interest rate does carry interest rate risk based on changing market conditions. In some cases, banks will offer a variable rate with a floor and a ceiling, meaning that the rate will not go below a particular percentage nor will it exceed a particular percentage. Such arrangements can be helpful for a church in limiting its ultimate risk. In evaluating the possibility of a variable rate loan, the church should consider the history of the particular rate, including highs and lows.

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Variable interest rates for church mortgages are based on an “index rate,” which is typically either the bank’s “prime rate,” (sometimes referred to as the “base rate”) or “LIBOR,” the London Inter-Bank Offered Rate.[2] The bank’s prime rate, while technically set by each bank, is generally the same as the prime rate used by banks across the United States, and is often the same as the prime rate published in *The Wall Street Journal* each business day. The prime rate changes periodically based on market conditions. LIBOR is a benchmark rate that some of the world's leading banks charge each other for short-term loans.[3] LIBOR typically changes much more frequently than the prime rate and can change daily. LIBOR is typically expressed in one-month, three-month, and six-month rates in the context of variable-interest-rate mortgages. LIBOR rates are published daily in *The Wall Street Journal* and numerous other sources.

When the prime rate is used as the index in a variable-rate mortgage, the most creditworthy borrowers can commonly borrow at the prime rate or less. Borrowers whose financial position or other attributes are not as strong may be quoted rates in excess of the prime rate.

When LIBOR is used, lenders commonly use the one-month LIBOR rate, and because the rate is so low (as of the date of this writing, the one-month LIBOR rate was less than one-quarter of one percent), LIBOR-based variable church mortgage rates are always stated as some percentage in excess of the LIBOR rate. The author has seen variable rates as low as one-month LIBOR +1.5 percent for extraordinarily strong borrowers.

Fixed interest rate loans offer the security of knowing the interest rate that will apply during the term for which the interest rate is fixed. Fixed-rate loans also offer protection from rising interest rates. Invariably, however, the fixed rate offered by a church lender is significantly higher than the variable rate available at the inception of the loan. Accordingly, churches must evaluate the pros and cons of these factors. A church may consider the fixed-rate option to be its best choice since the interest rate will not increase during the term of the fixed rate, and the church believes that it can refinance the loan in the event that rates decline significantly. In recent years, however, church lenders have more frequently begun to impose prepayment penalties in connection with fixed-rate loans. Sometimes, these prepayment penalties are substantial. As a result, a church with a fixed-rate loan that has a significant prepayment penalty may not be able to economically refinance the loan in the event interest rates decline significantly. While prepayment penalties for fixed-rate loans are more common than has historically been the case, they are, in the author’s experience, still relatively uncommon. A church considering a fixed-rate loan should carefully review the loan documents for prepayment penalty provisions and should avoid such provisions if at all possible.

Hedging Variable Interest Rate Risk

In response to lenders’ reluctance to offer long-term fixed-rate mortgages and the desire by borrowers for such mortgages, the financial marketplace offers various financial instruments designed to help borrowers mitigate their interest rate risk while allowing lenders to continue making variable rate loans. These financial instruments are “hedging instruments,” and they come in a variety of forms. The most common form of hedging instrument used by churches in today’s lending marketplace is an “interest rate swap” contract.

An interest rate swap contract (hereinafter referred to as a “swap”) is an agreement between the borrower (the church) and an investment banking firm (typically affiliated with the lender) in which the investment banking firm agrees to accept fixed interest payments from the borrower and to make variable interest payments to the lender. In other words, the borrower “swaps” the variable rate actually written into the loan agreement with a fixed rate that is accepted by the investment banking firm. A swap contract is a separate agreement from the loan documents and, accordingly, does not

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[2] Occasionally, lenders utilize a different variable-rate index, such as the Five-Year Treasury Constant Maturity Index, an index published by the Federal Reserve Board based on the average yield of a range of Treasury securities adjusted to the equivalent of a five-year maturity. (See www.bankrate.com.)

[3] Investopedia: http://www.investopedia.com/terms/l/libor.asp

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necessarily tie directly to the terms of the loan. In many cases, however, a swap agreement is drafted to align with the terms of the loan, including payment dates and principal balances, so as to have the effect of creating a fixed rate of interest on what is actually a variable rate loan. The advantage of a swap agreement to the borrower is that the interest cost related to the loan is fixed for the duration of the swap. The duration of the swap is a negotiable item, and it may or may not align with the maturity date of the loan. In some cases, a lender may require that the terms of a swap align with those of the related loan. Swaps are available with a variety of terms and a church considering such an arrangement should discuss it thoroughly with its lender, its financial advisors, and its legal counsel.

Since an interest rate swap contract is a separate contractual agreement from the loan itself, the swap itself has a value at any given time. The value to the borrower (the church) may be positive or negative depending on current market conditions. From a practical perspective, what this means is that if the borrower wishes to terminate the swap at any time, the borrower will either pay the investment banking firm to terminate the arrangement or the borrower will receive money from the investment banking firm in exchange for terminating the arrangement. Borrowers must understand this attribute of a swap. In a declining interest rate environment, the value of a swap will decrease and may go negative – substantially negative, which would mean that the church would be required to pay a substantial sum in order to terminate the swap. In a rising interest rate environment, the value of a swap will increase and may be positive, which would mean that the church would receive money from the investment banking firm if it were to terminate the swap. Swap agreements are complex documents and the detailed provisions are not likely to be well understood by people who do not practice substantially in the investment banking arena. Accordingly, if the amounts of money involved are substantial, a church faced with terminating a swap agreement may wish to obtain an opinion from an independent party as to the value of the swap, whether positive or negative. There is a current market of professionals who offer such services.

During the Great Recession, as interest rates declined significantly and remained low for a sustained period of time, many churches who entered into swap agreements regretted that decision. However, the future of interest rates remains uncertain and the market will determine the popularity of swap arrangements in the years ahead.

Loan Covenants

Loan agreements virtually always contain certain conditions that the borrower agrees to meet or maintain during the term of the loan. These provisions are often referred to as “loan covenants.” Loan covenants vary substantially from lender to lender and from loan to loan.

Financial Covenants

One type of loan covenant frequently found in church loans is “financial covenants” – covenants stating that the church will maintain certain specific financial benchmarks during the term of the loan.
The three most common financial covenants written into church loan agreements are: a minimum cash reserves covenant, a debt service coverage ratio covenant, and a debt-to-net assets covenant.

Minimum Cash Reserves Covenant

As mentioned above in “The Four or Five C’s of Credit in Church Mortgage Financing,” some lenders will stipulate as a condition of making a mortgage loan that a church maintain a minimum balance in a cash debt service reserve account at all times while the loan is outstanding. The amount of the required reserves is a matter of professional judgment and discretion applied by the lender and is typically equal to several months of debt payments.

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Important Note about Cash Reserves Covenants

While a cash reserves covenant imposed by the lender may seem to have the favorable impact of forcing the church to maintain a debt service reserve, when the debt service reserve requirement is a contractual part of the loan, special consideration is required. When a church maintains a debt service reserve on its own volition (without a contractual requirement), the church can actually use a portion of the debt service reserve if necessary to maintain consistent operating cash flows. However, when the debt service reserve is contractual, the church cannot spend the reserve balance below the required minimum without triggering an event of default under the terms of the loan – which, at a minimum, will require a waiver or approval by the lender. For this reason, if a church has a contractually required minimum debt service reserves covenant, the church should maintain an additional debt service reserve above and beyond the contractual minimum in order to ensure that the church has funds that it can actually use in the event that they are needed without triggering an event of default under the terms of the loan.

Debt Service Coverage Covenant

As mentioned above in "The Four or Five C's of Credit in Church Mortgage Financing," lenders will assess the church's debt service coverage ratio (DSCR) in the loan approval process, regardless of whether the DSCR is expressed as an ongoing covenant in the loan agreement. The DSCR is typically calculated as follows:

Most recent year's change in unrestricted net assets + depreciation expense + interest expense
Divided by
Next year's required debt payments (principal and interest)

(Some variations in the details of the DSCR calculation vary from lender to lender and from church to church, based on specific facts and circumstances.)

The idea behind this ratio is to determine whether the cash available from operations is adequate to make the proposed debt payments. Some lenders will accept a DSCR as low as 1.1. However, many lenders require a DSCR of 1.25 or higher.

Important Note about DSCR Covenants

Given the fact that the DSCR calculation is made annually, is based on a particular year's cash flows, and does not take into consideration prior year cash flows or assets available to service debt, it is possible for a church to be in a very strong financial position and still violate a DSCR covenant. For example, assume that a church receives substantial unexpected contributions in a given year and does not spend any of those additional funds during that year. For the year in which the substantial contributions are received, the church is likely to have a very large DSCR – well within compliance of the loan covenant. Assume that in the following year, the church spends one half of the unexpected contribution funds on a missions-related project, resulting in a net loss for that year (the funds were received in the prior year). Regardless of the fact that the church still has one half of the unexpected contributions in its accounts, the loss incurred during Year Two could cause the church to violate a DSCR covenant in that year.

While the author, of course, encourages churches to maintain a strong financial position, for the reasons described above, the author encourages churches to avoid having DSCR covenants in their loan agreements if possible. In the event a church finds itself in potential violation of a DSCR covenant for reasons like those described above, the church should pursue a waiver of the covenant from its lender in light of the unusual circumstances.

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Debt-to-Net Assets Covenant

The debt-to-net assets covenant is typically defined as the ratio of the church's debt or total liabilities to the church's unrestricted net assets balance as of each year-end. The idea behind this covenant is to ensure that the church's total debt or liabilities do not exceed the church's overall equity in its assets beyond a certain level. The debt-to-net assets ratio is typically expressed as a maximum and, if present, is typically in a range of 2.0 to 3.0.

Evaluating Financial Covenants in General

The lender may impose financial covenants other than those described above. For any financial covenants that a lender proposes to be included in the loan agreement, a church should carefully evaluate the covenant requirements, definitions, measurement methods, and measurement dates and have reasonable assurance that the church will be able to comply with the requirements on an ongoing basis during the term of the loan. The church should run "what-if" scenarios to evaluate the likelihood of compliance with financial covenants in different situations.

Nonfinancial Covenants

A church loan agreement may include a variety of nonfinancial covenants. Some of the more common nonfinancial covenants included in church loans are the following:

- A requirement that the church submit audited financial statements annually within a certain period after each year-end
- A requirement that the church submit internally-prepared interim financial reports (e.g., quarterly)
- A requirement that the church maintain its entire banking relationship with the lending bank (which requires moving the relationship if it is not already with the lending bank)
- A stipulation that the church will not incur any new debt without the lender's approval
- A stipulation that the church will not enter into any new long-term lease agreements without the lender's approval
- A limit on the amount of capital expenditures that the church can make without the lender's approval
- A stipulation that the church will not make any significant change in the nature or scope of its operations without the lender's approval
- A stipulation that the church will maintain its federal tax-exempt status

The Importance of Engaging Legal Counsel to Assist With Debt Financing

Mortgages and other loan documents are complex contractual agreements with many terms and provisions that can have significant implications for a church. In addition to loan covenant provisions such as those described above, loan documents typically contain numerous other legally significant provisions that can affect a church's costs or options in the future, depending on the circumstances that arise. It may be tempting for church leaders to view the many provisions in loan documents as simply "boilerplate" provisions that "are probably non-negotiable" or "are probably in all loan documents," and, thus, to pay little attention to them. Numerous churches have taken such an approach only to deeply regret it later when circumstances arise that bring to light the dramatic significance of provisions that they had deemed to be "boilerplate."

Accordingly, churches should have their own legal counsel review all mortgage and other loan documents before they are signed to ensure that the church's interests are adequately considered. (While the lending institution may have legal counsel involved in the loan document preparation process, the bank's legal counsel does not represent the interests of the church.) Additionally, a church should never assume that any provision in a lender-prepared loan document is non-negotiable. Banks and other lending organizations frequently make changes to loan documents based on requests made by borrowers or their legal counsel.

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Tax-exempt Financing for Church-operated Private Schools

Due to developments in federal and state law in recent years, it has become possible in many states for church-operated private schools to obtain tax-exempt financing for their facilities. While the details of these arrangements are outside the scope of this piece, the author would like readers to be aware of this possibility. Churches that operate or control private schools may wish to consider tax-exempt financing if they qualify. While tax-exempt financing is somewhat complex in nature, it typically offers interest rates that are substantially below those that are otherwise available to churches and schools in the marketplace. The author is aware of circumstances in which tax-exempt financing has saved church-operated schools hundreds of thousands of dollars per year in interest costs. Interested churches should consult their lenders and legal counsel with specific experience in tax-exempt financing for private schools.

Bond Financing

As an alternative to financing provided by bankers and other traditional lenders, churches sometimes turn to bond financing to provide funds for real property acquisition, construction, improvement, or refinancing. With bond financing, investors hold the church's debt. The church's bonds are sold to the investors either by the church directly or by a bond underwriting firm.

Bond financing is sometimes used in order to permit a church to establish a truly long-term fixed interest rate for its debt without a prepayment penalty. Bond financing is also used in some cases by churches that are not able to obtain credit from traditional lenders in other ways.

Church bond issues are generally issued on either a "firm" underwriting or a "best efforts" basis. A firm underwriting is a bond issue in which the bond underwriter guarantees the sale of all of the bonds, ensuring that the church will receive the full proceeds of the bond issue, net of applicable costs. As the term implies, a best efforts bond issue is one in which "best efforts" are made to sell the bonds with no guarantee as to what portion of the bonds will be sold and the amount of proceeds the church will receive.

Issuing bonds is a complex legal process and should only be undertaken under the advice of highly experienced and competent legal counsel who is knowledgeable about federal and state securities law as well as church bond law. Because of the complexity involved in issuing bonds, there are typically substantial up-front costs associated with a church bond issue. The church must consider the advantages provided by a church bond issue as compared with traditional borrowing in light of the higher up-front costs.

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