

VII. STANDING COMMITTEES

B. Finance, Audit & Facilities Committee

Internal Lending Program Update

INFORMATION:

The material presented here offers background information on the Internal Lending Program Report that will be presented to the Board of Regents at the July 2009 meeting. The information in this backgrounder is intended to supplement the presentation to the Board.

Attachment

Internal Lending Program Backgrounder

Internal Lending Program Report (July 2009)

Backgrounder

- **Internal Lending Program.** The Internal Lending Program (ILP) was adopted in mid-2008 after receiving new legislative authority to issue local debt for any university purpose. The ILP makes internal loans to campus borrowers and manages repayment in accordance with financing agreements between the campus borrower and the institution. The University bundles those internal loans and borrows externally to secure the funds for those loans.
- **Reporting.** The Treasury Office reports annually to the Board on ILP activities over the prior year, including an overview of the University's external debt portfolio, the status of internal loans, and institutional debt capacity.
- **Annual Bond Resolution.** The annual ILP Report is accompanied (as a separate Board action item) by an annual bond resolution, which authorizes both the issuance of new debt during the upcoming year and the refunding of existing bonds for economic and portfolio restructuring purposes. The annual bond resolution is limited in the amount of debt that can be issued over the upcoming 12 months. This year's annual bond resolution also includes new authority for debt repayment for the Molecular Engineering Building project using building fee revenue.
- **Accomplishments.** Fiscal Year 2009 was an exceptionally difficult period in the credit markets, highlighted by the collapse of Lehman Brothers and serious dysfunction in certain short-term bond sectors. Amidst this turmoil, the University used its highly-rated credit in June to lock-in a subsidized market interest rate of 3.9 percent on a \$75 million long-term debt issue using the new Build America Bond program – the first use of the program in Washington state.

The University has also taken advantage of low interest rates on the short end of the yield curve through commercial paper borrowing, with rates averaging well under 1.0 percent. The Treasury Office is requesting Board approval (as a separate Board action item) of a self-liquidity platform to backstop the commercial paper program – with annual savings that could reach as much as \$2.5 million at today's rates for backup liquidity services.

- Loans and borrowings. In the prior fiscal year, the Board authorized \$293 million in internal loans to fund the J-Wing, PACCAR Hall, Accreditation Facilities, Student Housing, and Molecular Engineering Building projects. In a separate action, there are \$149 million in new internal loans for Student Life renovation projects before the Board for approval. Based on outstanding debt, approved loans, and loans up for approval in July, the University's total outstanding debt is expected to reach \$1.4 billion in 2014.
- Rate stabilization. The ILP offers a uniform internal lending rate to all campus borrowers. The internal lending rate includes a small reserve component for rate stabilization that will be used to subsidize the internal lending rate if increases in external borrowing rates put upward pressure on the internal rate.

The rate stabilization reserve has to be large enough to offset substantial increases in external borrowing rates – otherwise, the internal lending rate will have to be raised in order to preserve the solvency of the ILP. Because the ILP is relatively new, the rate stabilization account cannot currently offset any meaningful volatility in external borrowing rates. However, based on projected external borrowing over the next 24 months, the Treasury Office does not foresee the need to raise the internal rate at this time.

- Debt structure. The University's external debt portfolio is comprised primarily of amortizing fixed-rate debt issues. Two recent debt issues were non-amortizing ("bullet maturity") fixed-rate issues, which adds structural diversity to the debt portfolio at a relatively low cost. Given the ILP's internal payment structure, non-amortizing debt also enhances income cash flow, which has a positive effect on the accumulation of the rate stabilization reserve. With the Build America Bonds issued in June 2009, the choice of a non-amortizing debt structure was based on factors related to the taxable bond market.
- Credit rating and debt capacity. Over the past year, the Treasury Office worked closely with Moody's and Standard & Poor to maintain the University's Aa1 / AA+ credit ratings (one "notch" below the highest AAA rating). Among the 156 public universities ranked by Standard & Poor's in FY2008, the University of Washington was among the top 8 in credit rating, with only 3 public universities at the higher AAA level (Michigan, Virginia, and the University of Texas system).

The University's credit rating is a function of the amount of the institution's debt outstanding compared against its financial resources. The University is currently projected to have about \$2.1 billion of debt outstanding in 2018. Based on the current forecast of University financial

resources in 2018 and Moody's FY2007 medians for public universities, the University would maintain its Aa1 credit rating with the currently projected debt load in 2018. However, the Treasury Office estimates that if the debt load exceeded about \$3.0 billion in 2018, the University could be downgraded to Moody's lower Aa3 level. It is important to keep in mind that ratio analysis is just one component of the UW's credit rating. Other components include market position, pricing power, and revenue diversification.

- Forward calendar. The Treasury Office expects to issue a long-term bond of up to \$150 million later this year to discharge \$30 million in outstanding commercial paper, fund \$53.5 million in Molecular Engineering, Phase 1 expenditures, refund \$25 million in outstanding debt for the 4225 Roosevelt Clinic, and fund cash flows for previously approved projects. The final amount and timing of this bond will depend on market conditions and actual cash flows.

UNIVERSITY OF WASHINGTON

DEBT MANAGEMENT ANNUAL REPORT



BOARD OF REGENTS
FINANCE, AUDIT AND FACILITIES COMMITTEE
JULY 16, 2009

DISCUSSION OUTLINE

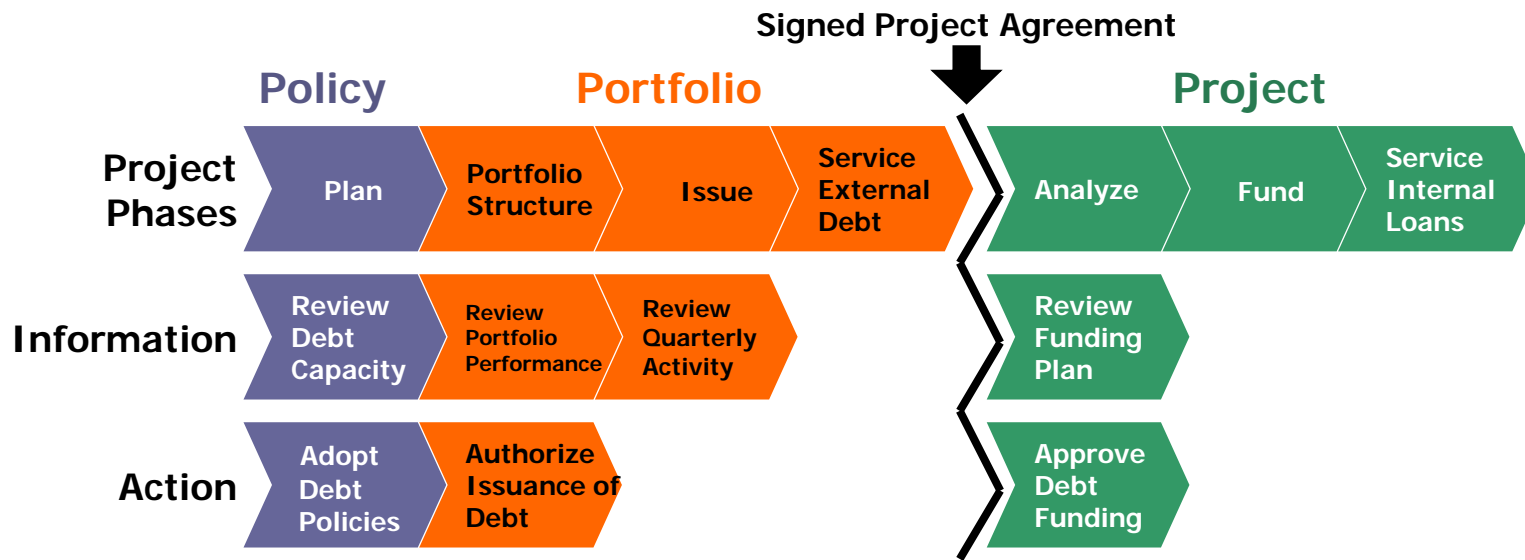
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DEBT MANAGEMENT OUTLOOK

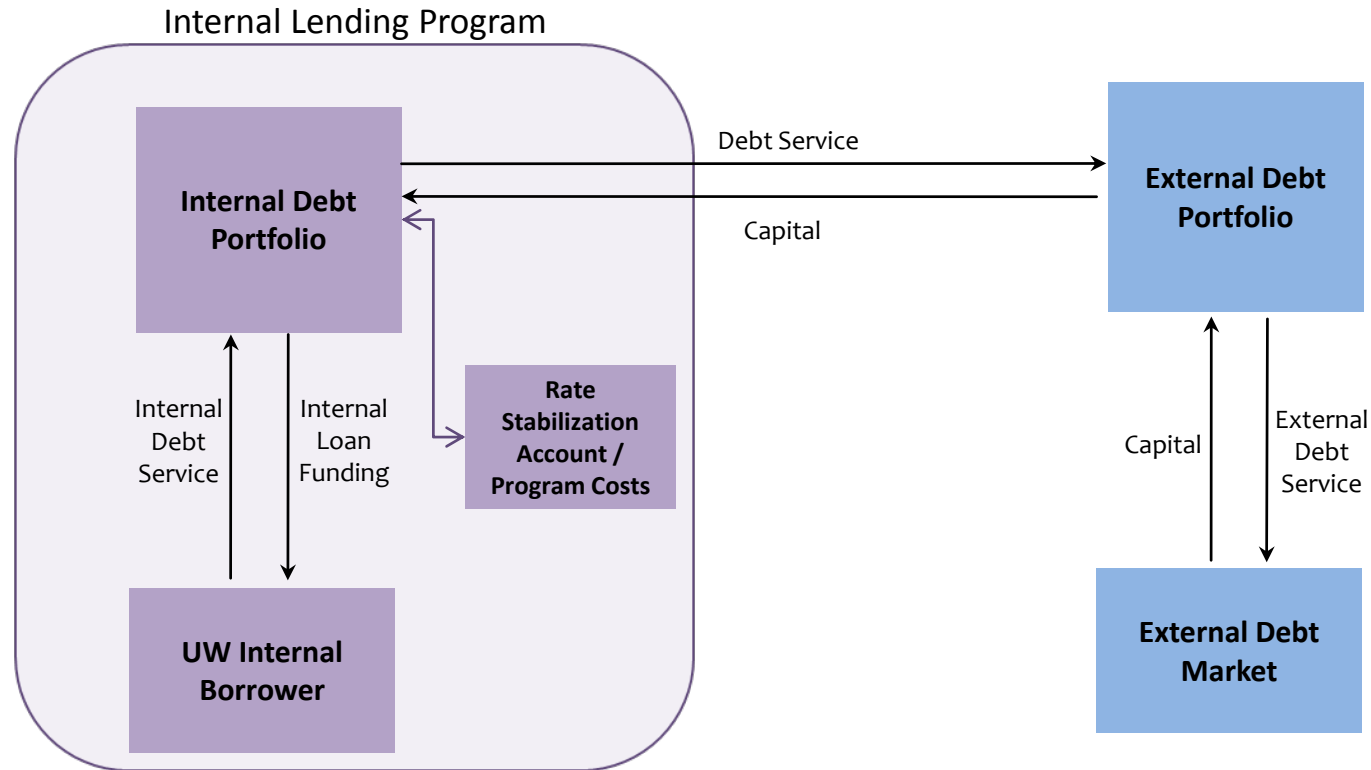
- The University has an aggressive capital plan – about \$1 billion over 10 years. At the same time, State funding is declining, growth in federal research dollars is uncertain, and overall revenues are slowing, thus making prioritization of capital projects critical.
- With likely continued uncertainty in credit markets over the next few years, forecasted borrowing will put pressure on the University's ability to maintain the institution's Aa1/AA+ credit rating, thus possibly leading to higher external borrowing costs.
- Notwithstanding future borrowing plans, the cost of debt is likely to be higher at some point given massive federal spending, thus challenging the University's ability to maintain the 5.5% internal lending rate.

REGENT ROLES

- Adopt debt management policy
- Establish University credit standards (“A” category rating or better)
- Oversee debt outstanding, credit ratings, and compliance with bond covenants and IRS regulations
- Adopt bond resolutions to allow for issuance of external debt
- Approve use of Internal Lending Program to fund capital projects



MISSION & STRUCTURE



- Ensure quality underwriting and monitor new and outstanding obligations
- Fund rate stabilization account to minimize increases in the internal lending rate

- Maintain cost effective access to the debt markets
- Seek opportunities to reduce long term institutional borrowing costs

ACCOMPLISHMENTS

Maintain Cost Effective Access to the Debt Markets

- Provided updates to rating agencies on UW financial position throughout credit crisis
- Reaffirmed overall Aa1/AA+ credit rating
- Received highest self liquidity rating

Ensure Quality Underwriting and Monitoring of New and Outstanding Obligations

- Implemented uniform audits for ICA, HFS, Parking, and Student Life
- Completed credit reviews for 8 new projects
- Reaffirmed credit analyses on previously approved projects

Seek Opportunities to Reduce Long Term Institutional Borrowing Costs

- Created debt management advisory team (including Deputy State Treasurer) to help evaluate market trends and develop a debt portfolio structure

Minimize Likelihood of Internal Lending Rate Increase

- Issued \$76M in Build America Bonds, reducing overall cost of ILP debt by 10 basis points

Improve Communications and Operations

- Improved internal stakeholder communication with Quarterly ILP Report and Monthly Liquidity Report
- Implemented comprehensive database, improving efficiency in debt management and accounting

GOALS

Maintain Cost Effective Access to the Debt Markets

- Implement commercial paper self liquidity program for \$2.5M in annual savings
- Continue proactive communications with rating agencies

Ensure Quality Underwriting and Monitoring of New and Outstanding Obligations

- Establish risk criteria for determining level of due diligence on new projects

Seek Opportunities to Reduce Long Term Institutional Borrowing Costs

- Implement long term strategy for debt portfolio structure
- Evaluate asset liability management strategies

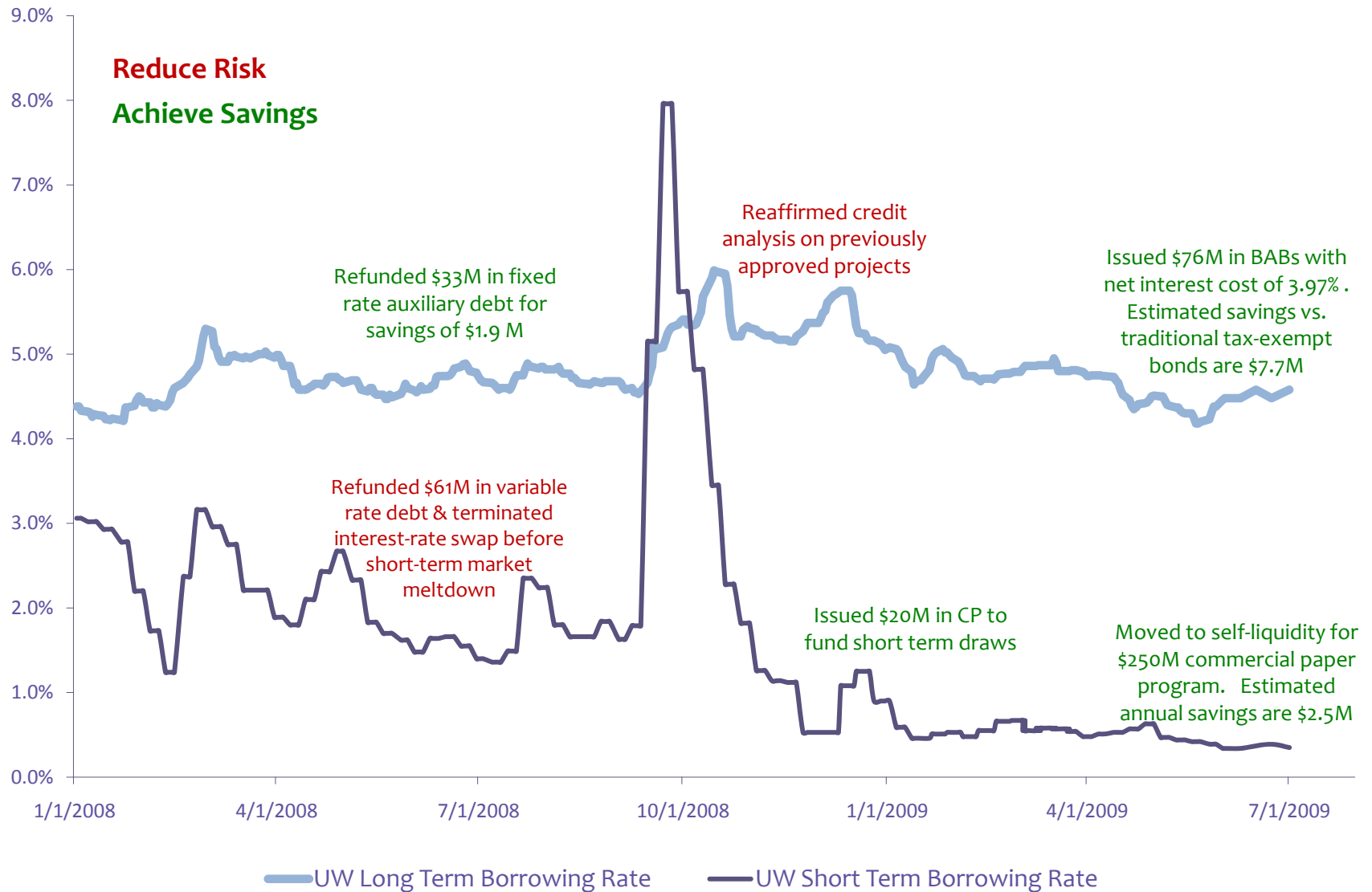
Minimize Likelihood of Internal Lending Rate Increase

- Establish rate stabilization guidelines
- Evaluate issuing additional Build America Bonds prior to end of 2010

Improve Communications and Operations

- Partner with Planning and Budgeting to develop a capital planning process
- Periodically track and report debt and other key financial ratios

MANAGING THE DEBT PORTFOLIO IN AN UNCERTAIN MARKET



EXTERNAL DEBT PORTFOLIO

Type of Debt	Issued FY09	Total Outstanding	Weighted Average Rate	Weighted Average Maturity (yrs)
Commercial Paper	\$30	\$30	0.4%	0.02
Variable Rate	0	0	n/a	n/a
Fixed Rate	76	621	4.6%	15.8
ILP Total	106	651	4.4%	15.1
Non-ILP Debt	0	376	5.1%	13.1
Total	\$106	\$1,027	4.7%	14.4

(Dollars in Millions)

ILP ASSETS

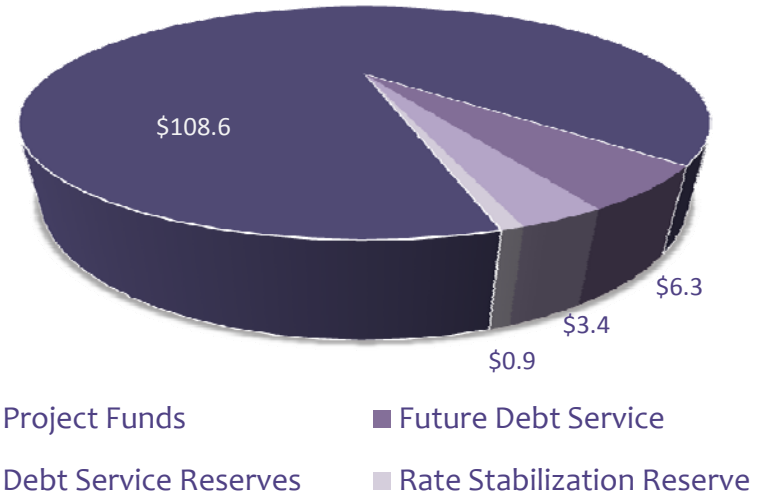
Cash

Beginning Balance July 2008	\$42.9
Internal Debt Service	57.3
External Debt Service	(50.2)
Net Debt Proceeds	70.3
Expenses	(1.1)
Ending Balance June 2009	119.2

Internal Loan Portfolio	575.8
Total Assets	\$695.0

(Dollars in Millions)

Cash Balances (\$119.2M)



INTERNAL RATE ASSESSMENT

The ILP rate will remain at 5.5% for the next 12 months

- External rates are lower than the ILP rate
- Recent \$76M issuance locked in a rate of 3.97%
- The first year of the ILP added \$900K to rate stabilization account (RSA)
 - Based on current cash flows and recent borrowing cost, the RSA will have \$2.2 MM by the end of FY 2010
 - The relatively small size of the RSA means that it cannot withstand much rate volatility

INTERNAL BORROWER PROFILE

Borrower	Current Outstanding	Additional Approved	Non-ILP Debt	Potential Exposure
Central	\$271.6	\$116.7	\$87.1	Additional budget cuts, decline in ICR reimbursements
School of Medicine	99.2	0	182.3	Decline in external support payments & ICR reimbursements
UWMC	76.4	156.0	18.8	Decline in patient revenues and state support
Student Life	44.1	150.0*	0	Student fee revenue less than forecast
Housing & Food Services	62.8	164.0	87.4	Freshman class size & market sensitivity to rate increases
Intercollegiate Athletics	5.1	0	0	Large capital plan with limited incremental revenue
Parking	16.6	2.6	0	Market sensitivity to rate increases
School of Business	0	30.0	0	Gift revenue less than forecast, lower enrollment levels in E-MBA program
School of Dentistry	0	12.0	0	Patient revenue less than forecast
Totals	\$575.8	\$631.3	\$375.6	

(Dollars in Millions)

*To be approved July 2009

EXTERNAL BORROWING (BASED ON JUST-IN-TIME FUNDING)

Approved Project Name	Estimated 2010 Construction Draws
UWMC Expansion, Phase 1	\$60.4
Molecular Engineering	53.5
AAALAC	28.9
PACCAR Business School	22.6
Housing	20.6
UW Tower Tenant Improvements	12.8
Pediatric Dentistry	9.8
Student Life Projects	4.6
4545 ESCO Project	3.8
J-Wing (Microbiology)	3.2
West Campus Garage Addition	2.8
Alumni Association Tenant Improvements	2.0
Less: 2009 General Revenue Bond Proceeds	(75.0)
Total	\$150.0

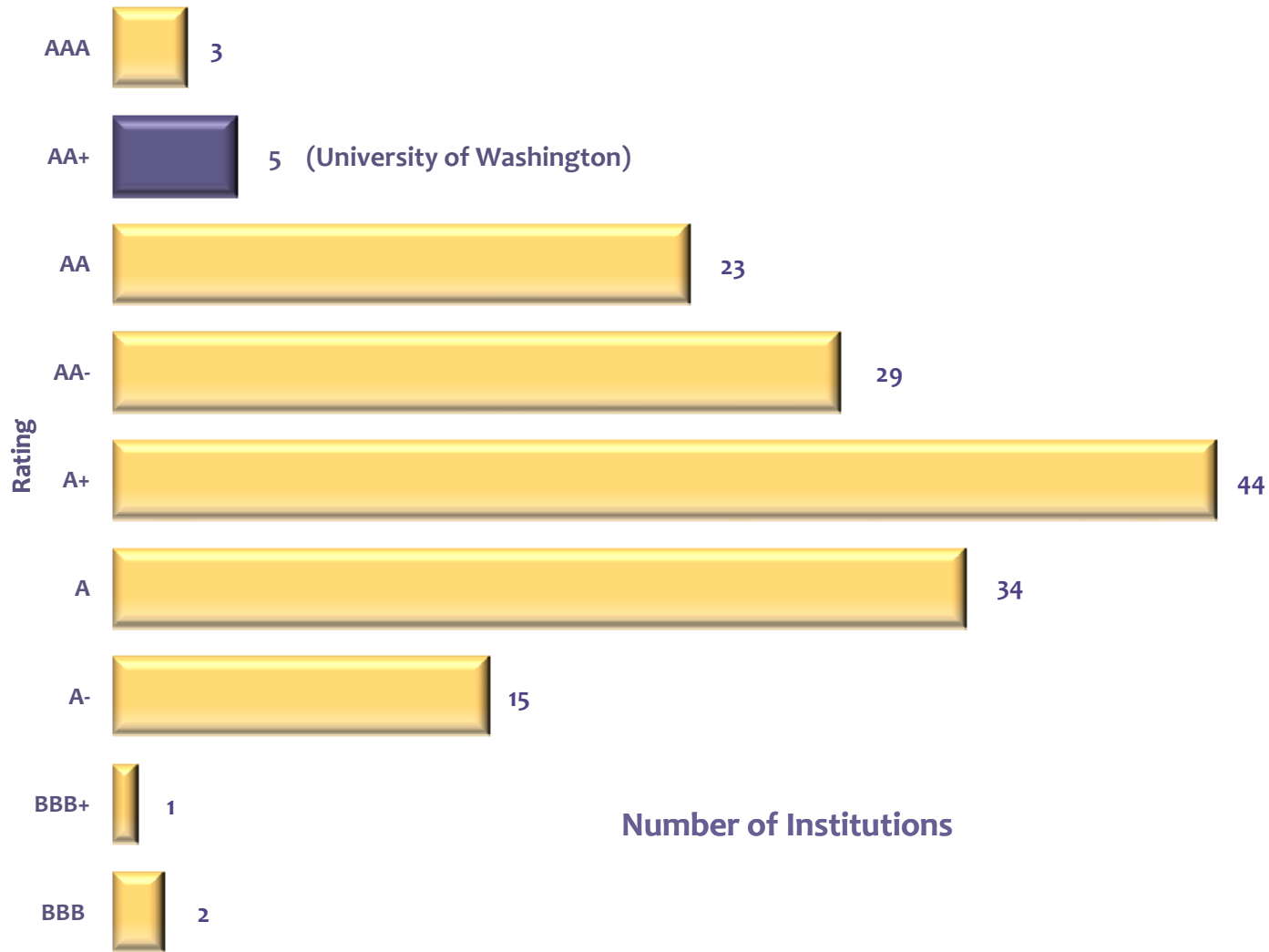
(Dollars in Millions)

FUTURE PROJECTS (IDENTIFIED, NOT YET APPROVED)

Future Project Name	Estimated Borrowing Amount through 2018
Student Housing, Phases 2-4	\$444
South Lake Union 3	167
UWMC Building Expansion, Phase 2	141
ICA Stadium Renovation	90
Research Building	45
Metro Tract	35
Sand Point Building 5	22
J-Wing, Phase 2	16
House of Knowledge Longhouse	14
AAALAC, Phase 2	10
Dentistry Research Lab	6
Total	\$990M

(Dollars in Millions)

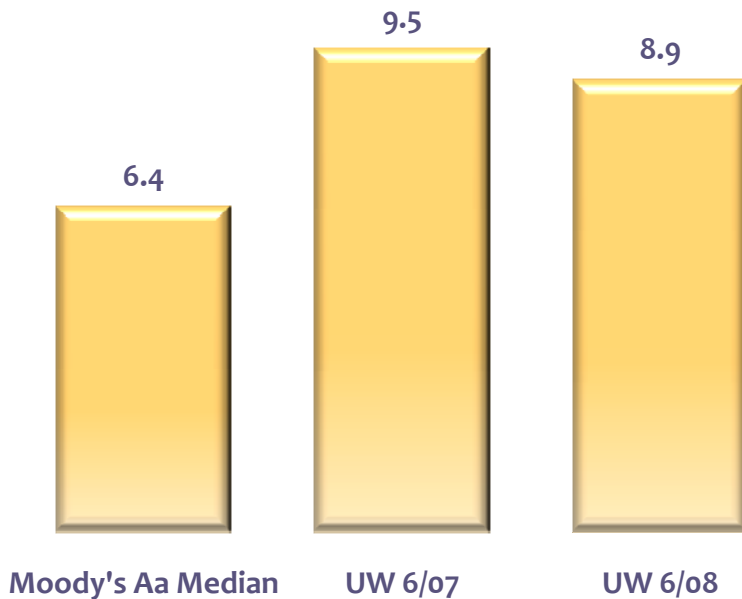
THE UNIVERSITY'S CREDIT RATING



Source: S&P's Public University Rating Distribution June 2009

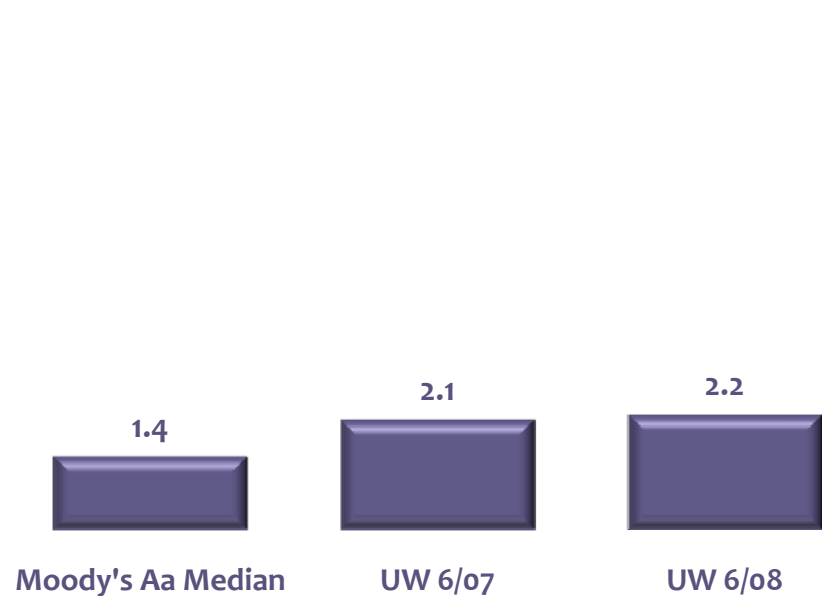
KEY FINANCIAL RATIO COMPARISON

Expendable Resources to Operations



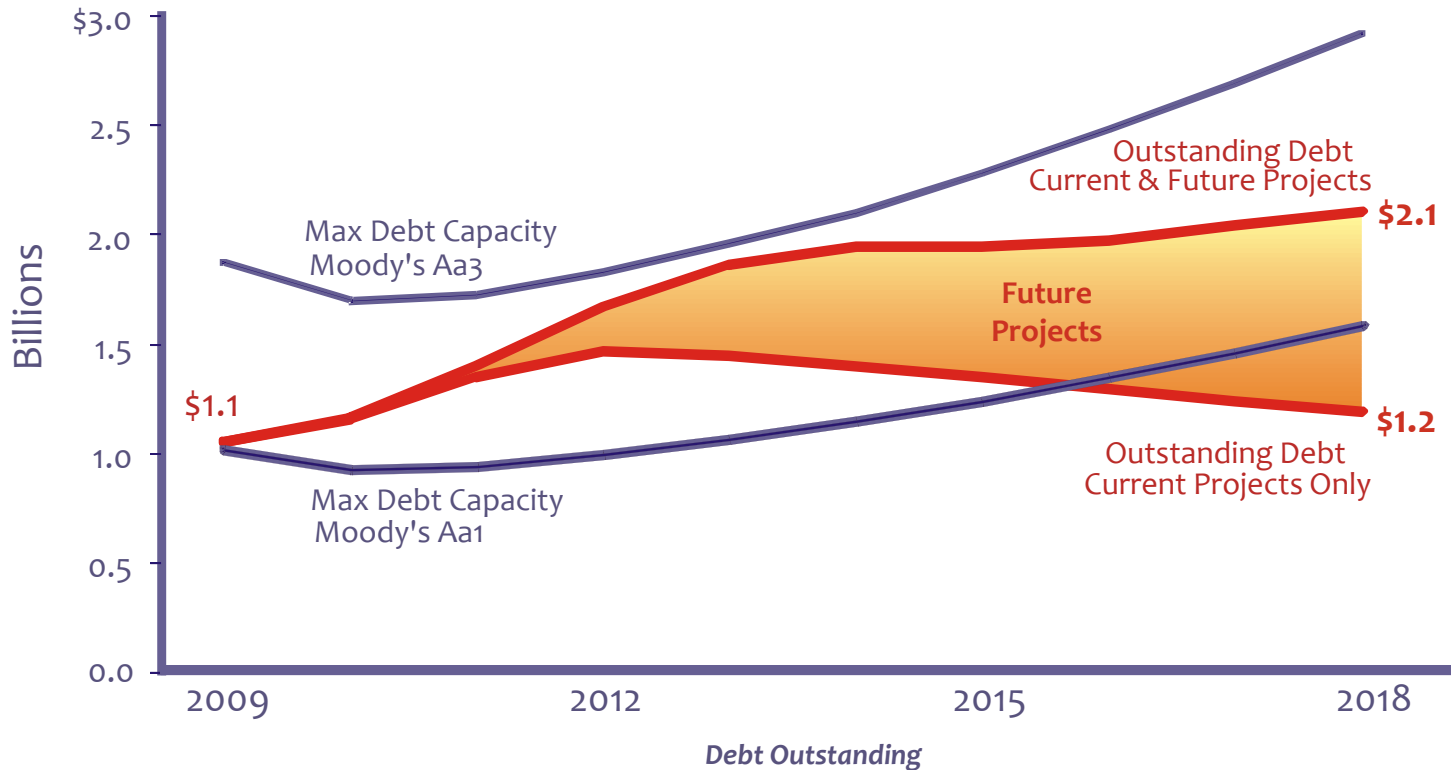
UW has nearly 9 months of expendable resources on hand to fund operations.

Expendable Resources to Debt



UW 's debt ratio is well above the median.

UW DEBT CAPACITY



	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Education	\$0.29	\$0.26	\$0.31	\$0.34	\$0.35	\$0.34	\$0.33	\$0.32	\$0.30	\$0.30
Research	0.36	0.36	0.36	0.37	0.40	0.43	0.43	0.43	0.45	0.45
Service	0.45	0.55	0.73	0.97	1.12	1.18	1.19	1.22	1.29	1.35
Total	\$1.10	\$1.17	\$1.40	\$1.68	\$1.87	\$1.95	\$1.95	\$1.97	\$2.04	\$2.10

(Dollars in Billions)

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