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 March 2010 meeting. The information in this backgrounder is intended to supplement the presentation to the Board.

Attachment
Internal Lending Program Backgrounder

Internal Lending Program Update
(March 2010)

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 bond resolution, which authorizes both the issuance of new debt during the upcoming year and the refunding of existing bonds, is presented to the Board for approval each July. The annual bond resolution is limited in the amount of debt that is expected to be issued over the next 12 months.

- Accomplishments. After an exceptionally difficult FY2009, access to the municipal credit markets eased with the introduction of the federal government's Build America Bonds Program. In November 2009, the University issued a second round of Build America Bonds for an historic low rate of 3.6% on a $78 million issue.

  The University continued to take 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 self-liquidity platform approved by the Board in July 2009 earned the University the highest self-liquidity rating issued by the national credit rating agencies.

- Loans and borrowings. In July 2009, the Board authorized $150 million in internal loans to fund the Student Life renovation projects.

- Rate stabilization. The ILP offers a uniform internal lending rate to all campus borrowers. The internal lending rate includes a 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. As of December 2009, the rate stabilization account was approximately $1.2 million.

However, based on projected external borrowing over the next 16 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. Three 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.

- Credit rating and debt capacity. The Treasury Office continues to work 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 209 public universities and colleges ranked by Moody's in FY2008, the University of Washington was among the top 9 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 FY2008 medians for public universities, the University would probably maintain its credit rating within the Aa category with the currently projected debt levels in 2018. 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 calendar year to fund cash flows for previously approved projects. The final amount and timing of this bond will depend on market conditions and actual cash flows. In addition, UW may issue Building Fee Revenue Bonds to fund campus projects and lease-backed bonds may be issued through a non-profit entity to fund the first phase of South Lake Union 3.

University of Washington
Debt Management Annual Report

Board of Regents
Finance, Audit and Facilities Committee
March 18, 2010

F-8/203-10
3/18/10

Discussion Outline

Debt Management Outlook

- The University has an aggressive borrowing plan – about $2 billion through 2022. 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.

- Credit markets have strengthened dramatically since September 2008. Bolstered by the Build America Bond program, Aa1/AA+ rated institutions like the University can currently issue long term debt at historic lows. Looking forward, the cost of debt is very likely to be higher given the massive federal deficit.

- Notwithstanding the potential impact of the federal deficit on interest rates, the high level of forecasted borrowing will put additional pressure on the University's credit rating, challenging the University's long term ability to maintain the 5.5% internal lending rate.

UW General Revenue Bond (GRB) Authority

Prior to 2003

- 63-20 financing
- Auxiliary revenue bonds

2003

General Revenue Bond (GRB) financing authority for research

- GRB platform established
- SLU-1 financed

2007

Expanded GRB financing authority for any University purpose

- Commercial Paper program established
- Safeco Tower purchased
- Internal Lending Program established

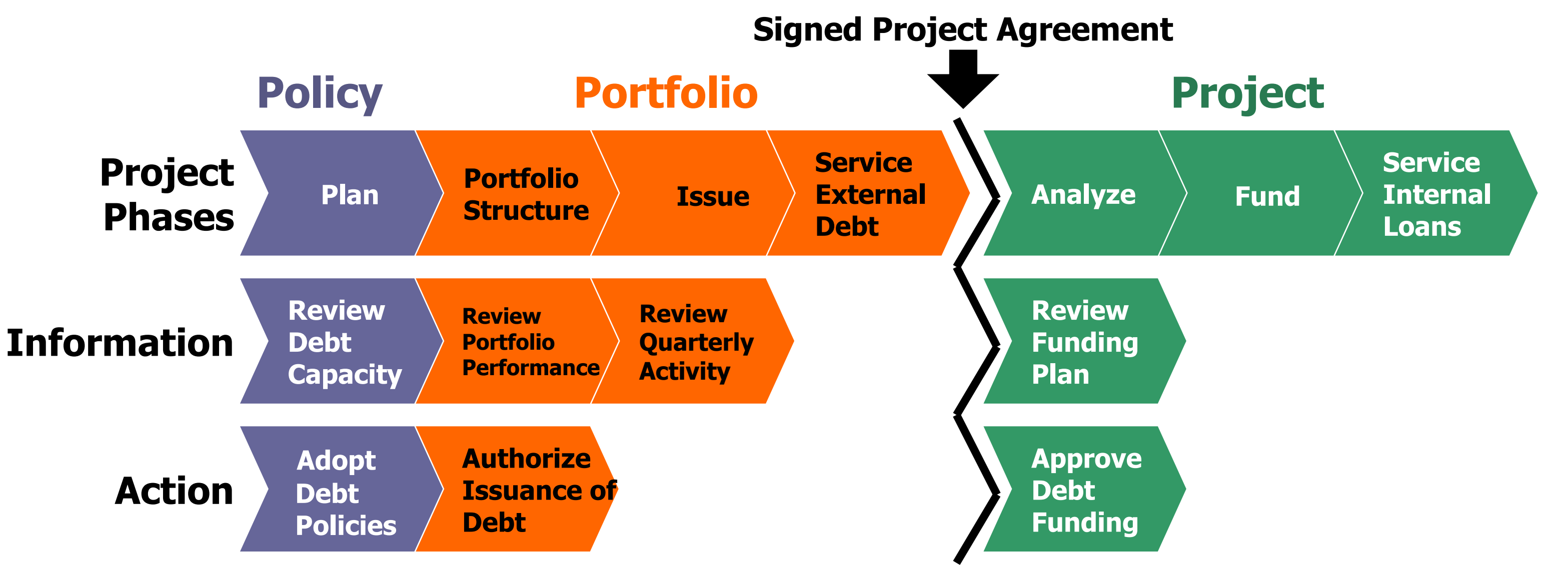
2009

Expanded GRB financing authority for Building Fee bonds

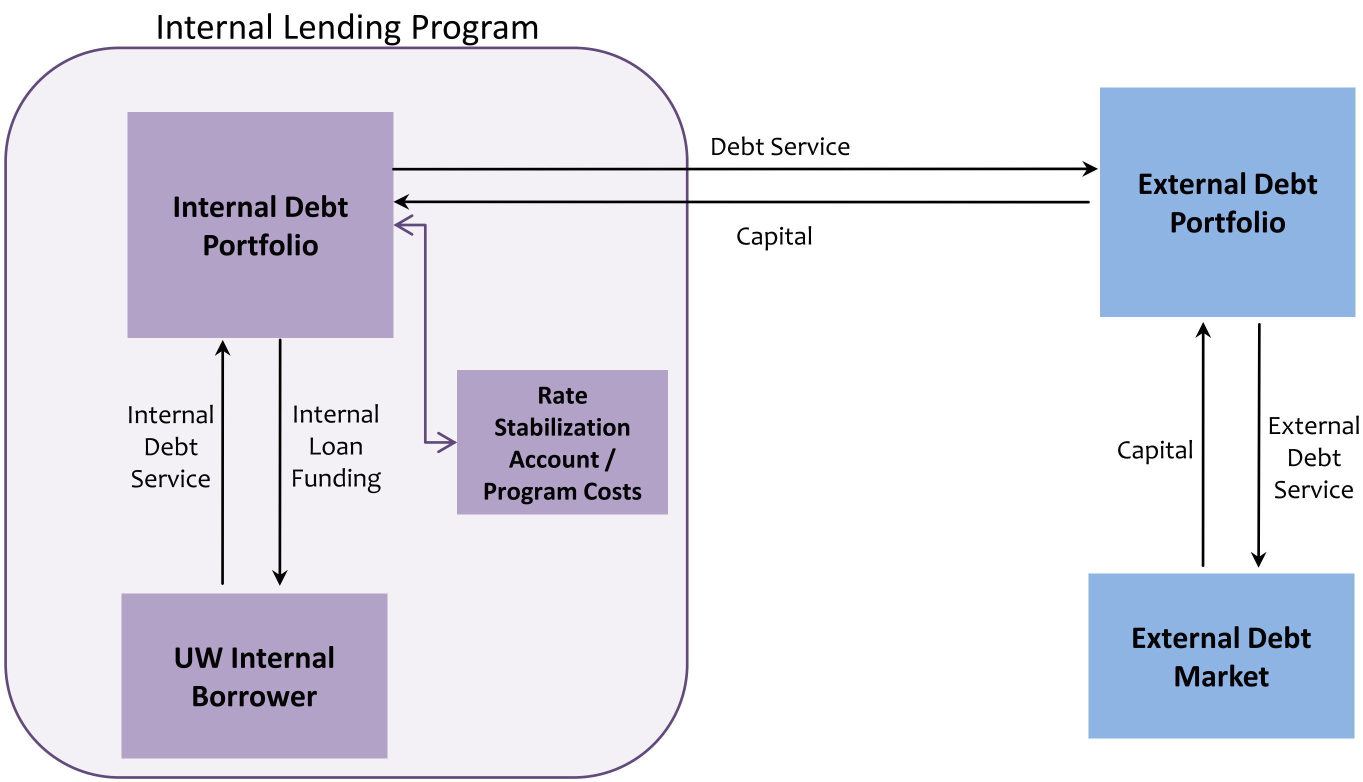
- Molecular Engineering Building financed

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

- Reaffirmed overall Aa1/AA+ credit rating, including site visit with head of Moody's Higher Education practice.

Ensure Quality Underwriting and Monitoring of New and Outstanding Obligations

- Completed uniform audits for Intercollegiate Athletics, Housing and Food Services, Parking, Student Life, and the Internal Lending Program.
- Completed credit assessments for Northwest Hospital, South Lake Union and Student Life.

Seek Opportunities to Reduce Long Term Institutional Borrowing Costs

- Issued $78M in Build America Bonds in November 2009 at 3.6%, reducing overall cost of ILP debt by 30 basis points – first issuer in State of Washington.

Minimize Likelihood of Internal Lending Rate Increase

- Structured fixed rate bullet maturities to reduce portfolio risk, minimize cash outflow and improve interest earning to support rate stabilization account.

Improve Communications and Operations

- Collaborated with Capital Resources Planning Office to develop One Capital Plan process.

Goals

Maintain Cost Effective Access to the Debt Markets

- Maintain AA1/AA+ institutional credit rating
- Refine institutional debt capacity model

Ensure Quality Underwriting and Monitoring of New and Outstanding Obligations

- Develop materiality standards for assessing borrowers' risk
- Perform annual review of ILP loans for compliance with financing agreements

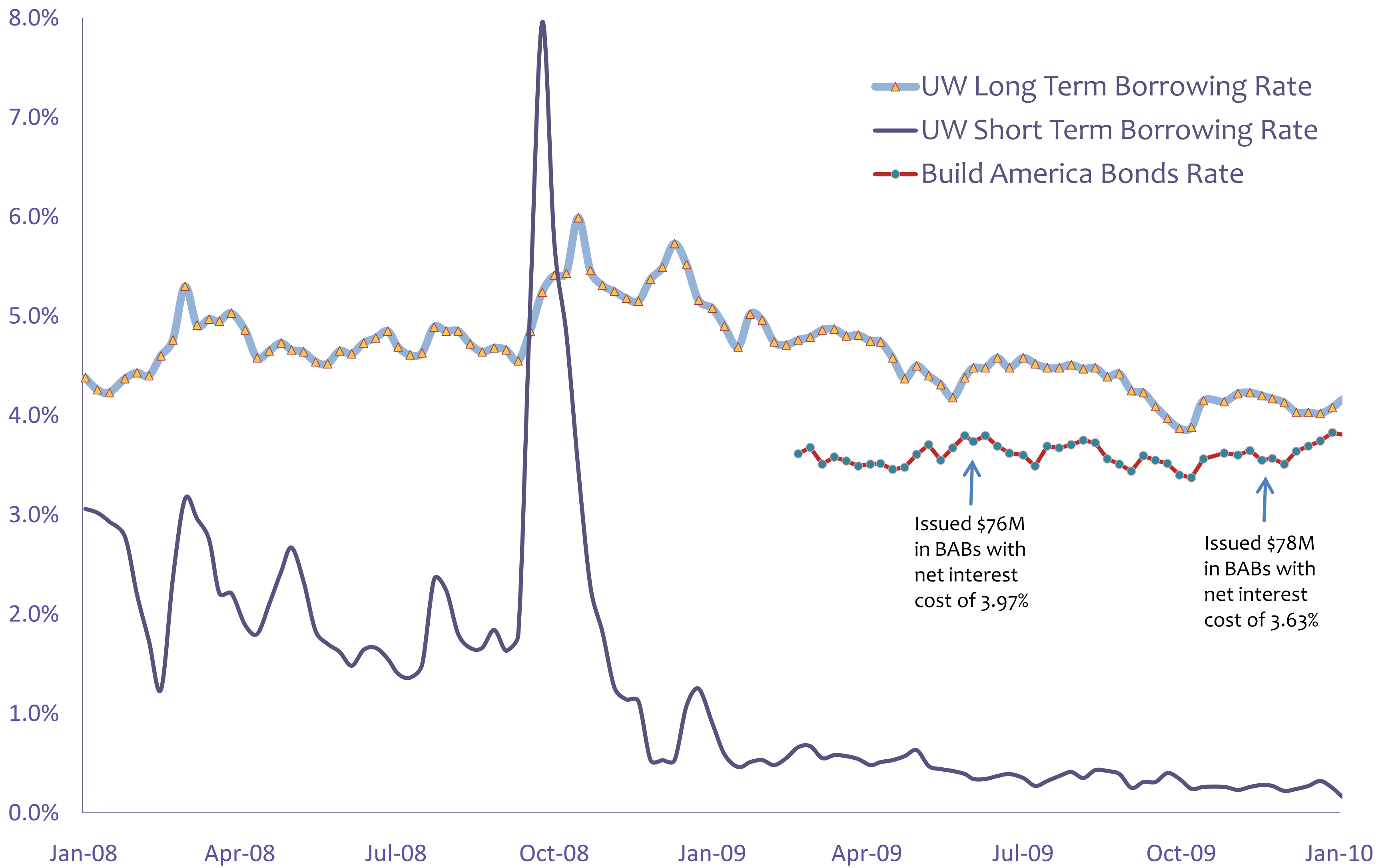
Seek Opportunities to Reduce Long Term Institutional Borrowing Costs

- Issue Build America Bonds (BABs) when lower cost than tax-exempt municipal bonds
- Take advantage of bond refunding opportunities if BABs program allows after 2010

Minimize Likelihood of Internal Lending Rate Increase

- Increase ILP rate stabilization fund

TAKING ADVANTAGE OF HISTORIC LOW RATES



Source: Seattle Northwest Securities

(AUDITED)

ILP Financial Statements – June 30, 2009

Income Statement
(dollars in millions)

Operating revenues	$30.5
Operating expenses	27.9
Operating income	2.6
Non-operating revenue	.2
Change in net assets	**$2.8**
Net assets at beginning of year	**$0**
Net assets at end of year	**$2.8**

Balance Sheet
(dollars in millions)

Assets	
Cash & short-term investments	$84.4
Current receivables	31.9
Current assets	116.3
Noncurrent receivables	553.0
Long-term investments	3.4
Total assets	**$672.7**
Liabilities & Net assets (equity)	
Current liabilities	$66.3
Noncurrent liabilities	603.6
Total liabilities	669.9
Net assets	2.8
Total liabilities & net assets	**$672.7**

Source: FY09 ILP audited financials

Cash Position as of December 2009

Ending Balance $147.3M

ILP Issued Debt Proceeds

Beginning Balance Jul-09	$87.8
Internal Debt Service	$28.0
External Debt Service	($23.5)
Net Debt Proceeds	$33.2
Expenses	($0.1)
Ending Balance Dec-09	**$125.4**

Legacy Debt Proceeds

Beginning Balance Jul-09	$32.6
Net Debt Proceeds	($10.7)
Ending Balance Dec-09	**$21.9**

Source: December 2009 ILP Quarterly

External Debt Portfolio

Type of Debt	Issued FY10	Total Outstanding	Weighted Average Rate	Weighted Average Maturity (yrs)
Commercial Paper	$0	$30	0.2%	0.02
Variable Rate	0	0	n/a	n/a
Fixed Rate	78	687	4.3%	16.1
ILP Total	**78**	**717**	**4.3%**	**16.1**
Non-ILP Debt	0	369	5.1%	12.9
Total	**$78**	**$1,086**	**4.6%**	**15.0**

(Dollars in Millions)

Source: December 2009 ILP Quarterly

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 $78M issuance locked in an all-in net rate of 3.63%
- Between July – December 2009 the ILP added $300K to rate stabilization account (RSA)
  - Based on current cash flows and recent borrowing cost, the RSA will have $1.8 M 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 ILP Outstanding	Additional Approved	Non-ILP Debt	Total	Potential Exposure
Central	$289	$99	$84	$472	Additional budget cuts, decline in ICR reimbursements, and limited additional fund sources for capital.
School of Medicine	97	0	181	278	Decline in external support payments & ICR reimbursements.
UWMC	98	131	17	246	Decline in patient revenues and state support.
Student Life	44	150	0	194	Student fee revenue less than forecast.
Housing & Food Services	71	161	87	319	Large capital plan reliant on growing freshman class size & market sensitivity to rate increases.
Intercollegiate Athletics	5	0	0	5	Large capital plan with limited incremental revenue. Minimal exposure on current outstanding debt.
Parking	18	0	0	18	Market sensitivity to rate increases.
School of Business	0	30	0	30	Gift revenue less than forecast, lower enrollment levels in E-MBA program.
School of Dentistry	0	12	0	12	Patient revenue less than forecast.
Totals	**$622**	**$583**	**$369**	**$1,574**	

(Dollars in Millions)

External Borrowing (based on just-in-time funding)

Approved Project Name	Estimated 2010-11 Construction Draws (next 16 months)
UWMC Expansion, Phase 1	$109.6
Molecular Engineering	62.9
AAALAC	5.7
PACCAR Business School	30.1
Housing	70.1
Pediatric Dentistry	9.3
Student Life Projects	41.9
J-Wing (Microbiology)	12.4
Alumni Association Tenant Improvements	.9
Less: 2009A & 2009B General Revenue Bond Proceeds	(95.0)
Total	**$247.9**

(Dollars in Millions)

Source: Capital Project Office Cash Flows, 1/2010

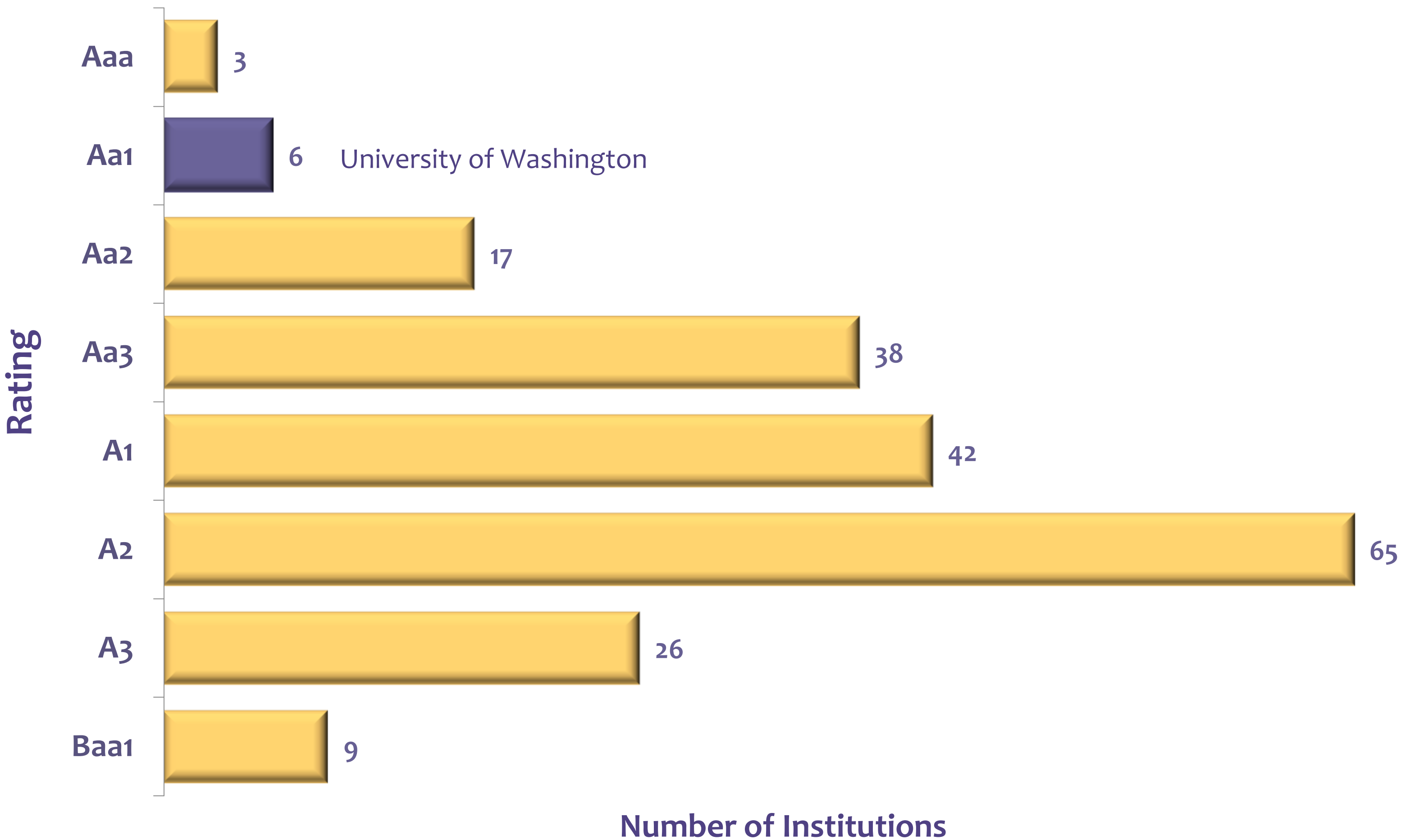
Future Projects (identified, not yet approved)

Future Project Name	Estimated Borrowing Amount through 2022
Student Housing, Phases 2-4	$716
South Lake Union 3, Phases 1-3	433
UWMC Building Expansion, Phase 2	70
ICA Stadium Renovation	90
Enterprise Information System	100
School of Business, Phase 2 – Balmer Hall	43
AAALAC, Phase 2	50
Sand Point Building 5	22
Rainier Vista Parking Garage Improvements	25
UW Seattle Structured Parking	12
Daycare Expansion	5
Total	**$1,566**

(Dollars in Millions)

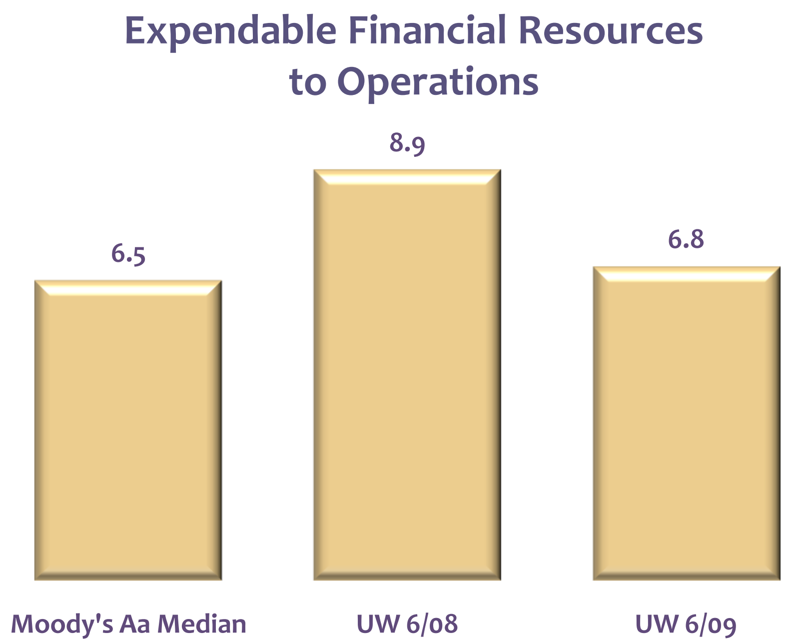
Source: "One Capital Plan", 11/09

The University's Credit Rating

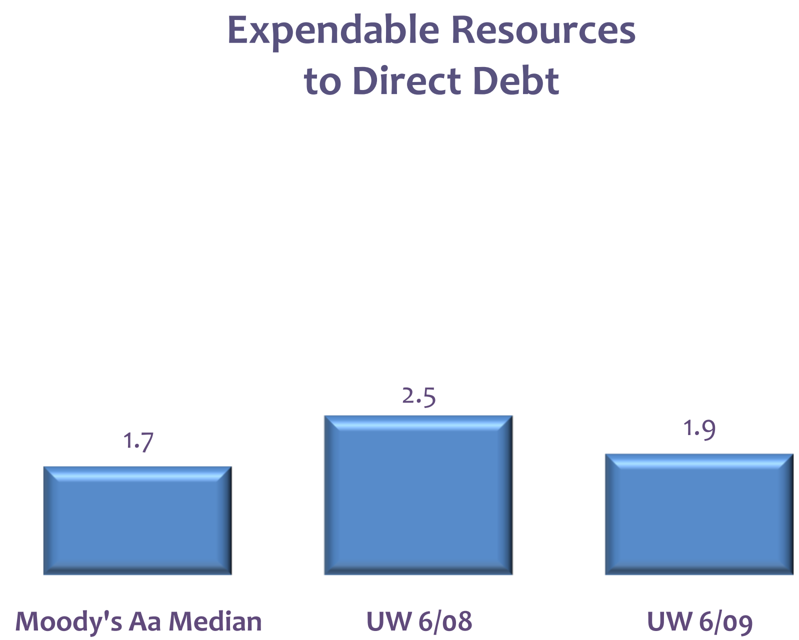


Source: Moody's Public University Rating Distribution July 2009

Key Financial Ratio Comparison



UW has nearly 7 months of expendable resources on hand to fund operations.



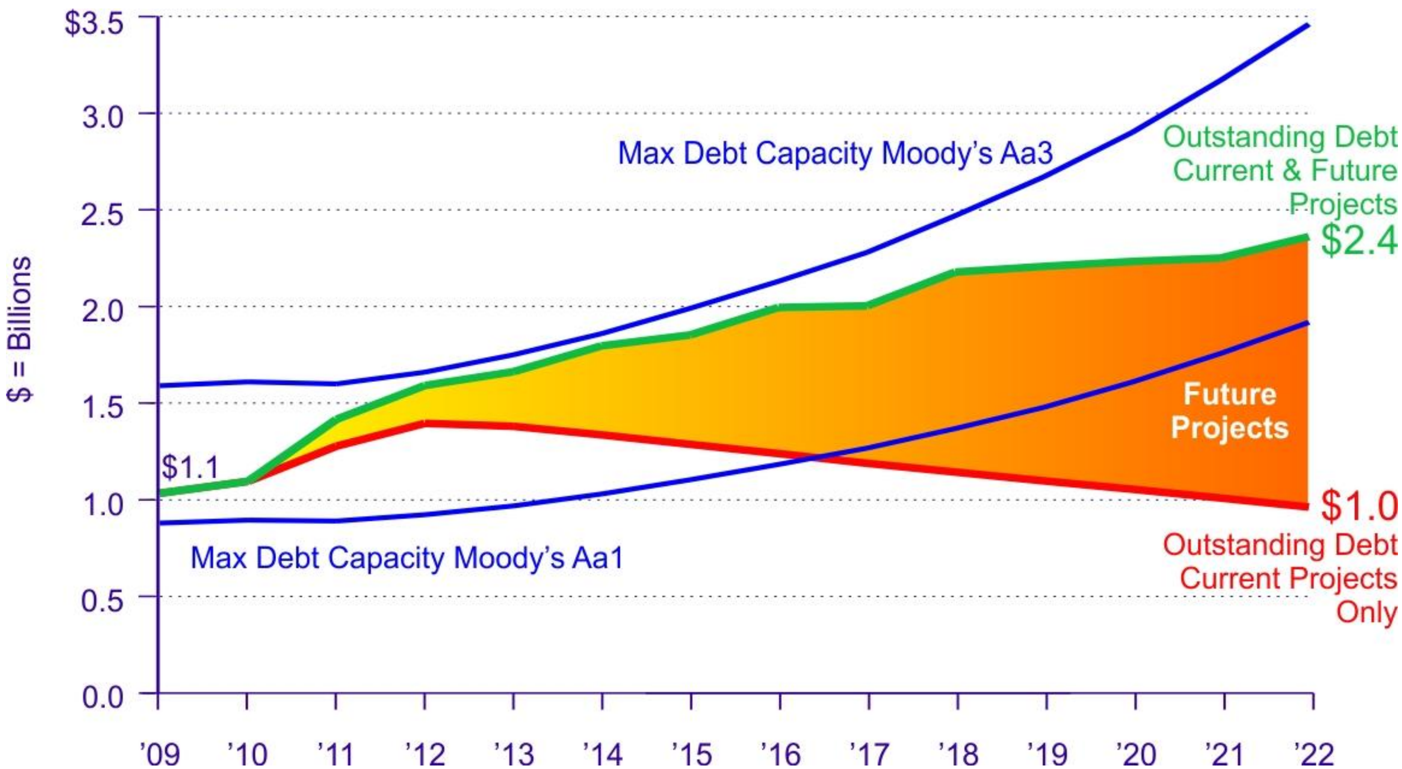
UW 's debt ratio is above the median.

PUBLIC COLLEGE AND UNIVERSITY SECTOR OUTLOOK:

- Moody's negative outlook for public and private colleges and universities continues, but the immediate pressure is easing due to improved financial markets.
- Most public institutions are expected to retain strong credit characteristics due to high student demand, but state support remains under pressure from declining tax revenues.

Source: Moody's median data for fiscal year 2008 for Aa rated public institutions of higher education.

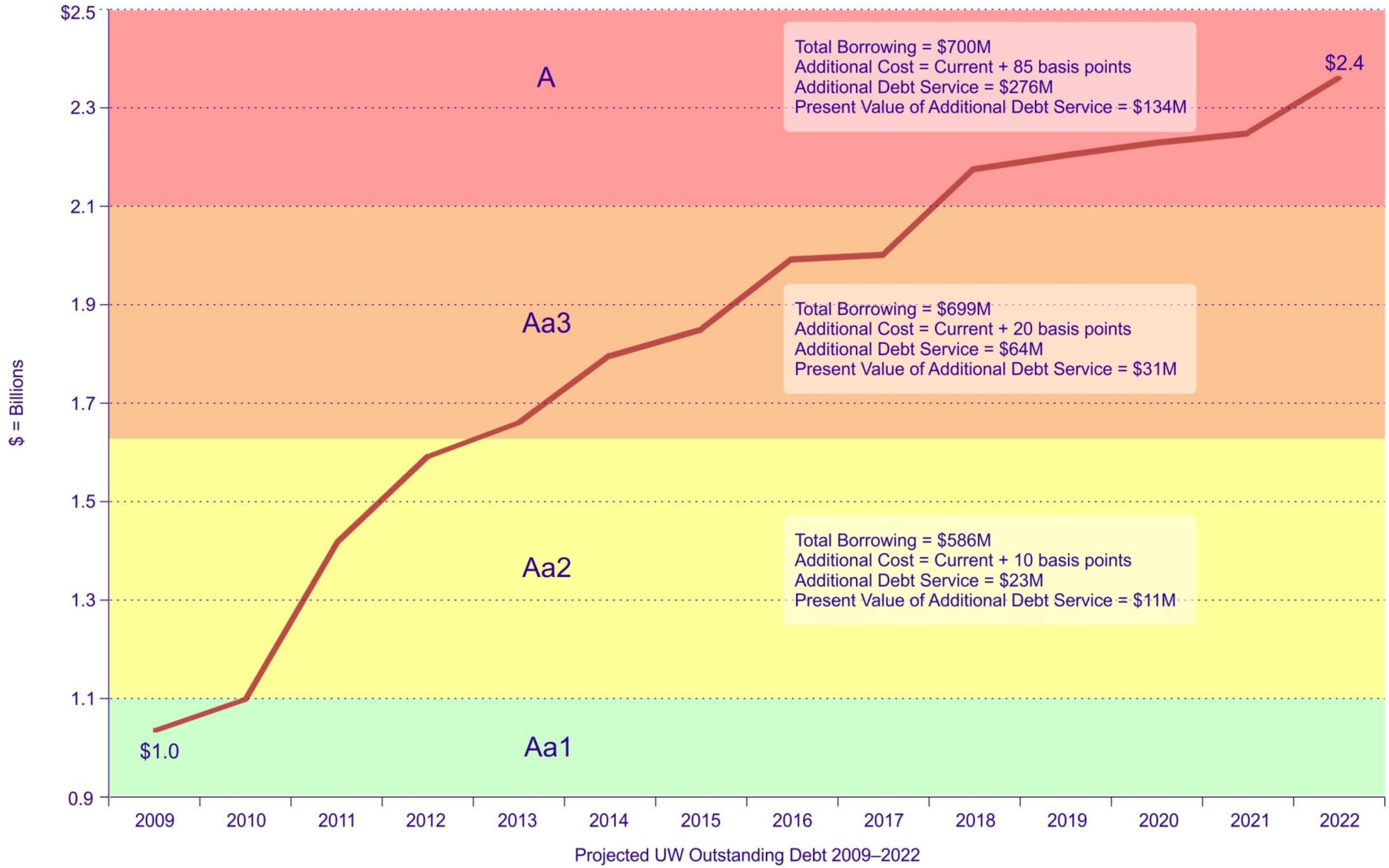
UW Debt Capacity



Debt Outstanding ($ = Billions)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
Education	$0.23	$0.24	$0.26	$0.28	$0.28	$0.28	$0.28	$0.28	$0.28	$0.28	$0.29	$0.30	$0.30
Research	0.36	0.51	0.50	0.48	0.51	0.50	0.61	0.58	0.70	0.68	0.66	0.64	0.61
Service	0.51	0.67	0.83	0.90	1.01	1.07	1.10	1.14	1.20	1.25	1.28	1.31	1.45
Total	**$1.10**	**$1.41**	**$1.59**	**$1.66**	**$1.80**	**$1.85**	**$2.00**	**$2.00**	**$2.18**	**$2.21**	**$2.23**	**$2.25**	**$2.36**

Estimated Additional Cost of Debt



- At current level of expendable resources (no growth assumed)
- Based on Moody's 2009 median "Expendable Resources to Debt"

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