VII. STANDING COMMITTEES

B. Finance, Audit and Facilities Committee

Internal Lending Program Risk Management

INFORMATION:

This will be an oral report for information only. The attached slides will be used during the presentation. They are provided here so that those who want to review them ahead of time have an opportunity to do so.

Attachment
Managing Risks in the Internal Lending Program

MANAGING RISKS IN THE INTERNAL LENDING PROGRAM

UW Board of Regents
Finance, Audit and Facilities Committee

July 21, 2011

Discussion Outline

- Executive Summary
- Overview
- Portfolio Management
- Ongoing Monitoring of Internal Loans

Executive Summary

- The UW has $1.65 billion in outstanding debt. The portfolio is 97% fixed rate with an overall rate of 4.4% (3.9% for ILP debt). The high level of fixed rate reflects a long term secular decline in interest rates
- The most significant risks facing the ILP are:
  - The cost of future debt over the next 4 years associated with funding $675 million in approved projects
  - The increased cost of a potential credit rating downgrade
  - The likelihood of an internal borrower facing declining cash flows and unable to fully service the loan
- The use of variable rate debt within defined policy ranges can lower the University's overall cost of funds
- External interest rates would have to significantly increase next year in order to trigger an increase in the ILP rate
- Robust credit analysis, ongoing monitoring, and regular reporting can provide early warning for borrowers in financial trouble

Overview:
ILP Goals & Decision Making

Program Goals

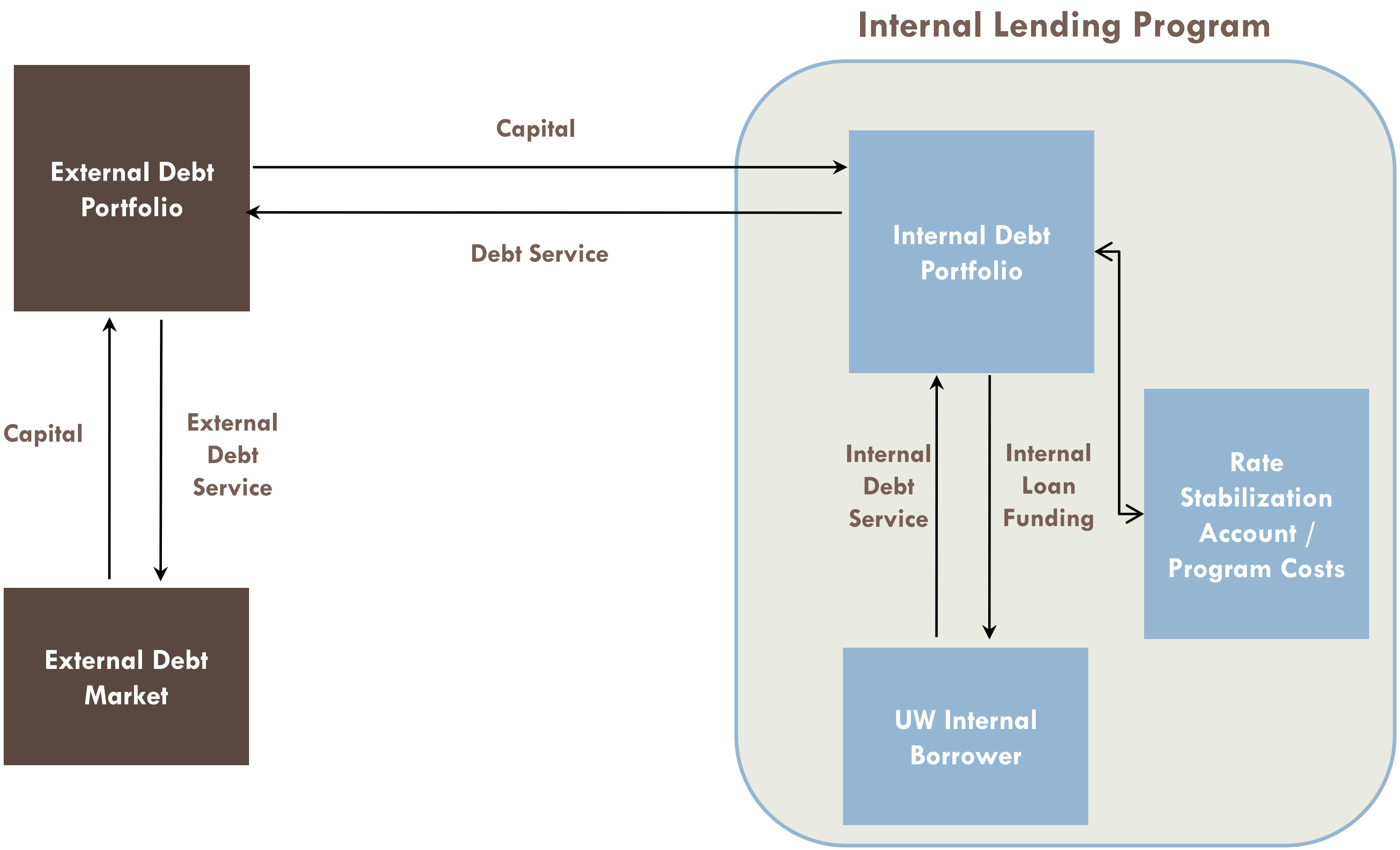
- Achieve lowest risk-adjusted cost of capital for the institution
- Provide stable and predictable rate for internal borrowers

Decision Making

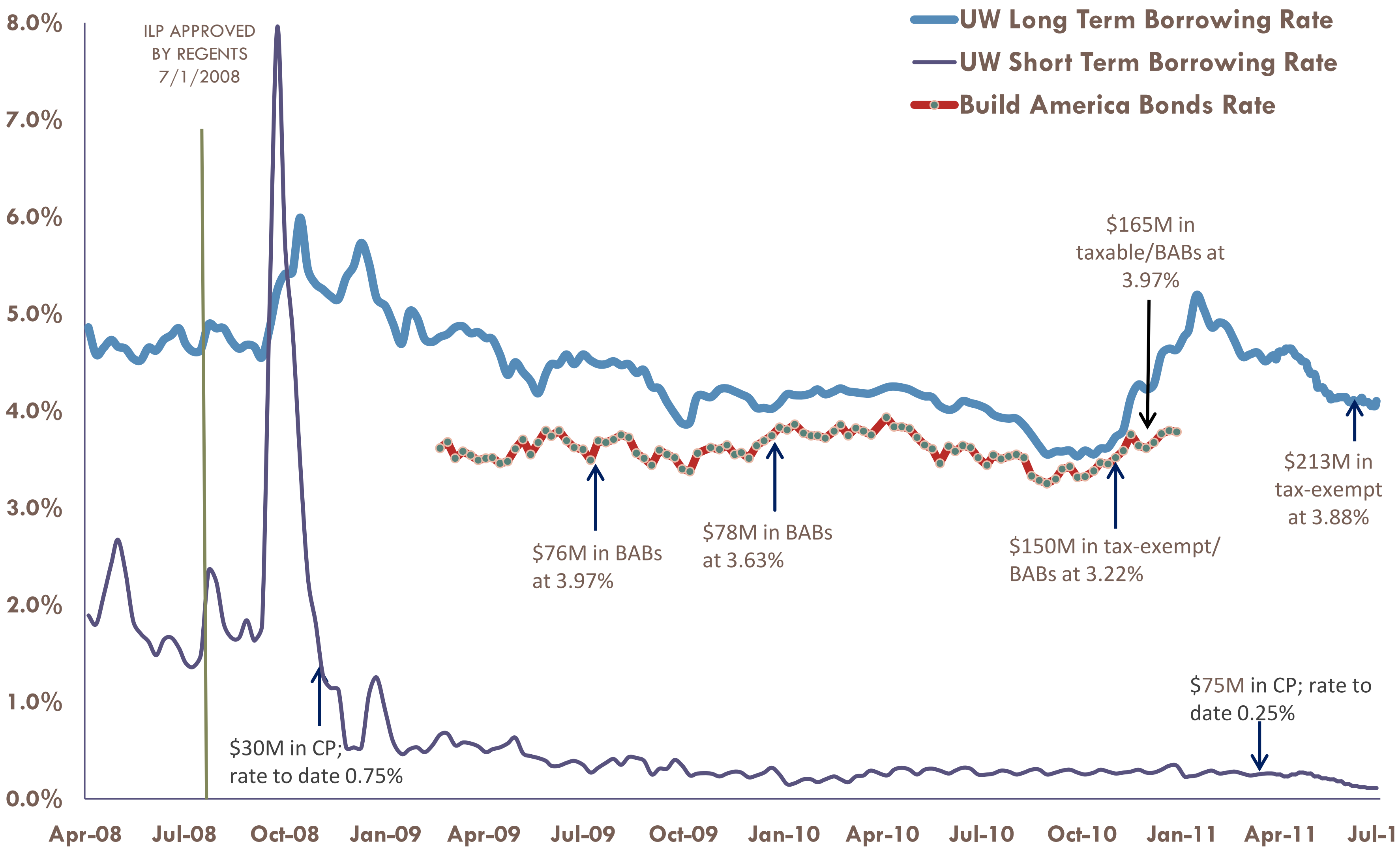
Debt Advisory Committee meets quarterly

- Reviews credit markets, debt strategy and structure for upcoming bond issues
- Membership includes Washington Deputy State Treasurer, UW's financial advisors, UW Investments team members, and underwriter representatives

Overview:
ILP Structure



Overview:
Historical Borrowing Decisions



Overview:
Risks & Mitigations

Risks \ Risk Mitigations	Project Due Diligence	Debt Portfolio Structuring	Using RSA Balance	ILP Rate Change	Ongoing Loan Monitoring	Central Support	Not Borrowing
Market Rate Increase		●	●	●			●
Borrower Impairment	●				●	●	
Credit Downgrade			●	●			●
Tax Law Changes		●	●	●			●
Remarketing Failure			●			●	●
Future Debt Issuance Risk			●	●			●

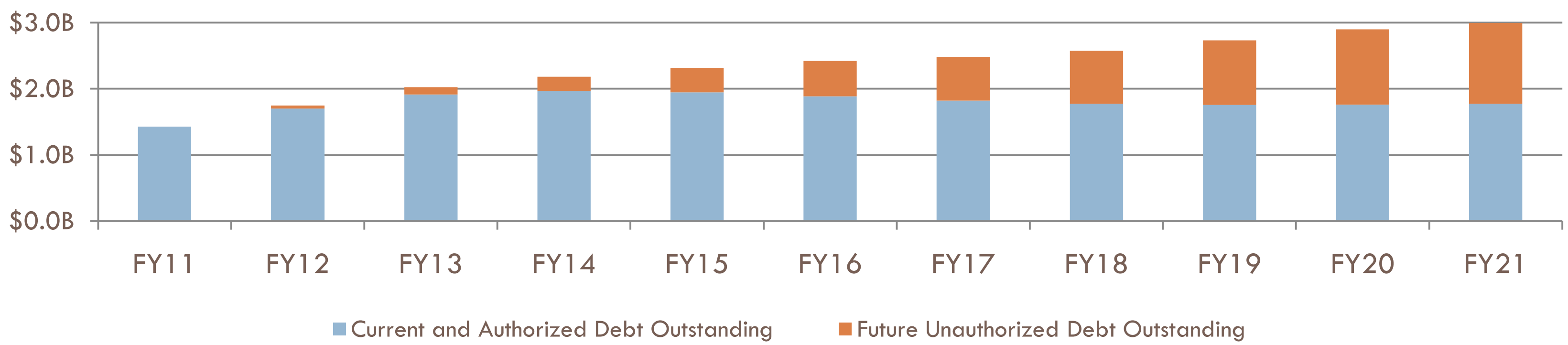
Overview:
Future & Outstanding Debt

The ILP rate is vulnerable to market rate risk, with $675 million in projected borrowing for authorized projects through 2015

Future Debt Issuance (in millions)

	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21
Authorized but Unissued Debt	287	272	119	48	7	0				
One Capital Plan + $25M/yr	43	70	108	158	169	138	164	239	246	188
Total Debt	**330**	**342**	**227**	**207**	**175**	**139**	**164**	**239**	**246**	**188**

Total Debt Outstanding *



* Amortization based on 30 year term and 5.5% blended interest rate.

Portfolio Management:
Future Borrowing Rate Sensitivity

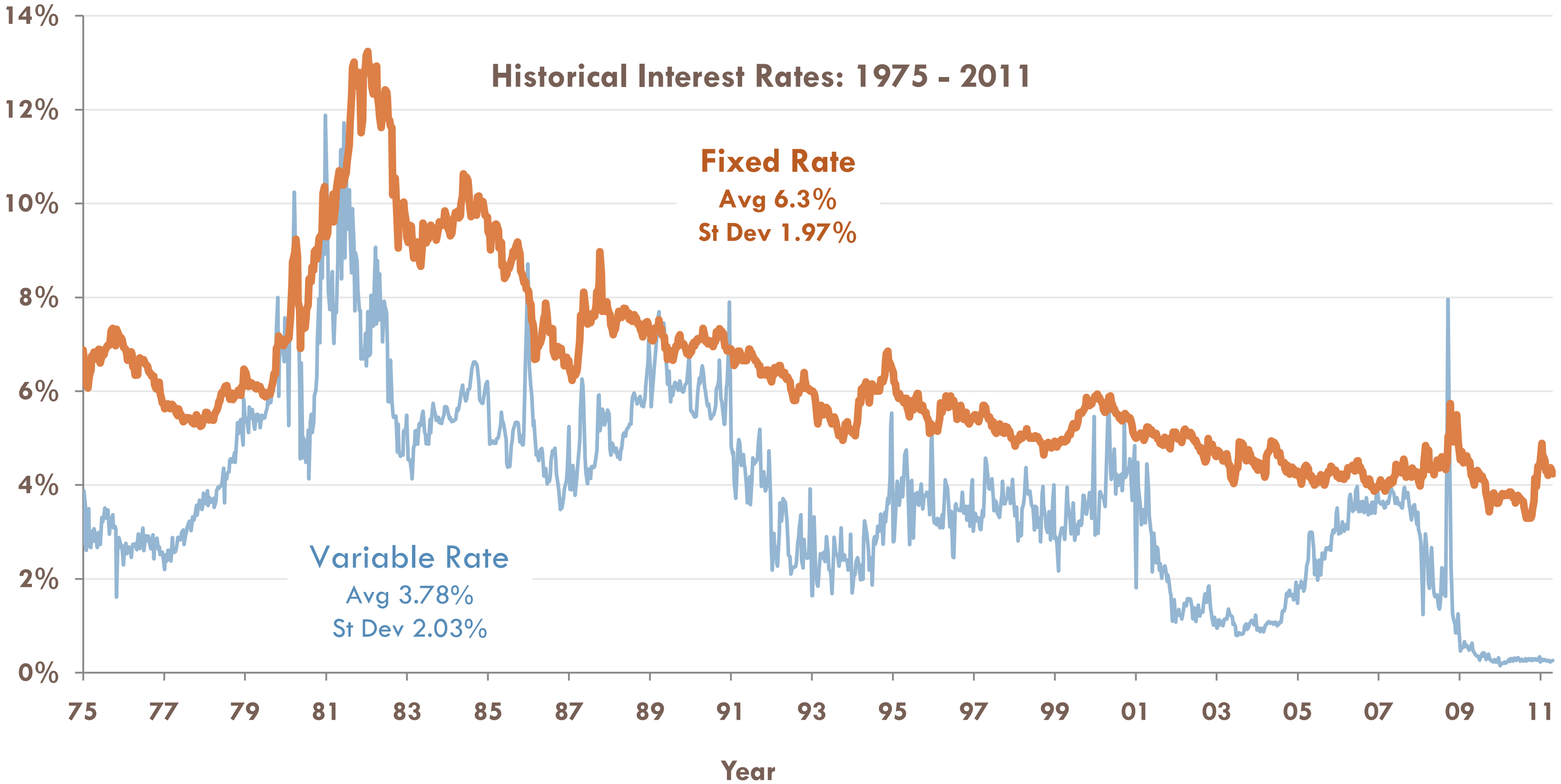
- Expected Borrowing in FY 2012 = $287 million
- Weighted Average Cost of Funds on current portfolio (including June 2011 Bonds) = 3.9%
- External interest rates would have to increase to nearly 7% in 2012 to increase the weighted average cost of funds to 5%
  - Under this scenario, the Rate Stabilization Account would still be funded
- External interest rates would have to increase to 8.5% in 2012 to increase the weighted average cost of funds to 5.5%
  - Under this scenario, there would be no ongoing funding for the Rate Stabilization Account, but existing balances would remain intact

Proposed Change To Debt Management Policy

- **Proposal**
  - Amend Debt Policy to set maximum variable rate debt exposure to 20% of debt portfolio (currently no limit on variable rate debt)
- **Risk-reward trade-off**
  - Variable rate debt has lower cost than fixed rate debt, but introduces rate and liquidity risks
- **Rationale for 20% limit**
  - Rating agencies impose higher scrutiny for issuers with more than 20% variable rate debt exposure
  - University's available liquidity support estimated at 25% of market value of cash and liquidity pools (currently $250 million available)
  - Peer institutions with variable rate debt exposure typically allocate 20% - 25% of debt portfolio to variable rate debt

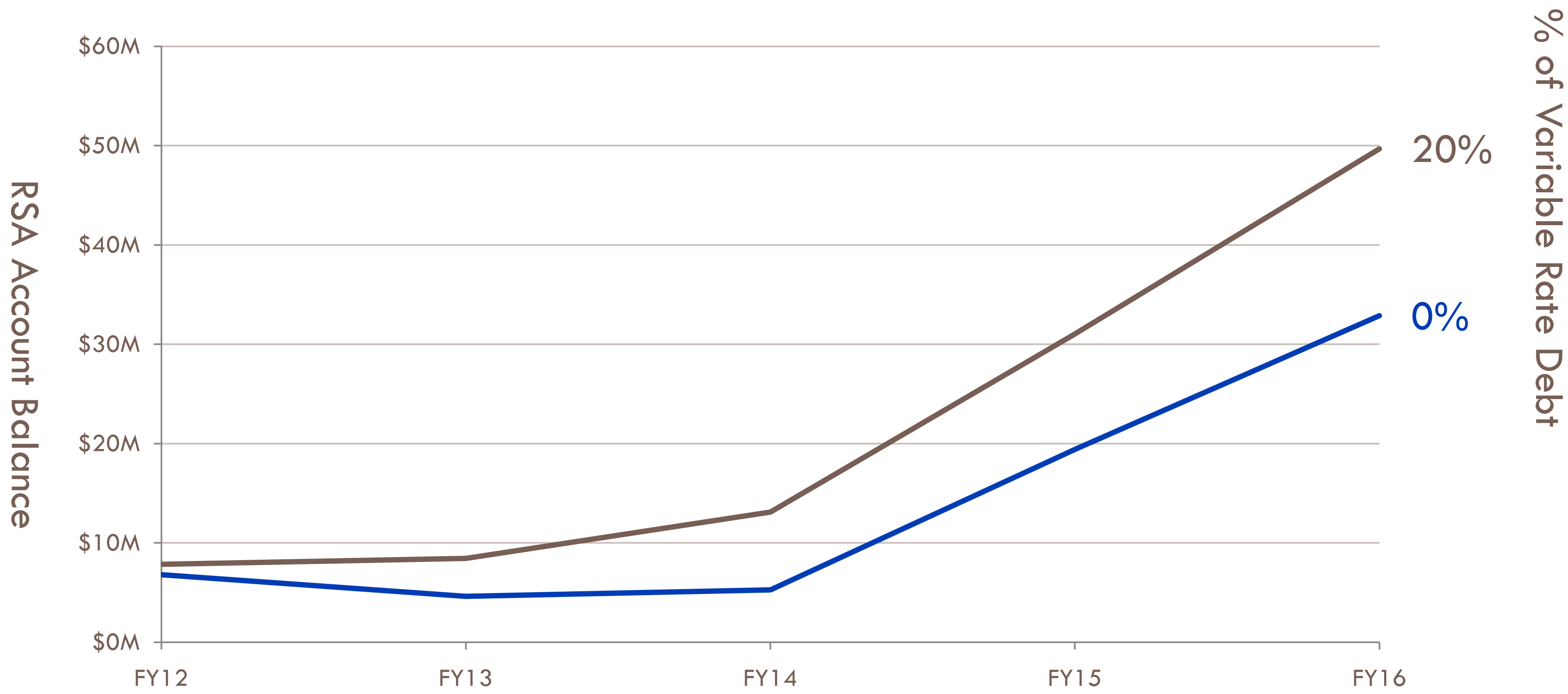
Portfolio Management:
The Role of Variable Rate Debt in Lowering the Overall Cost of Debt

Since 1975, fixed rates have been higher than variable rates with an average spread of 2.50%.

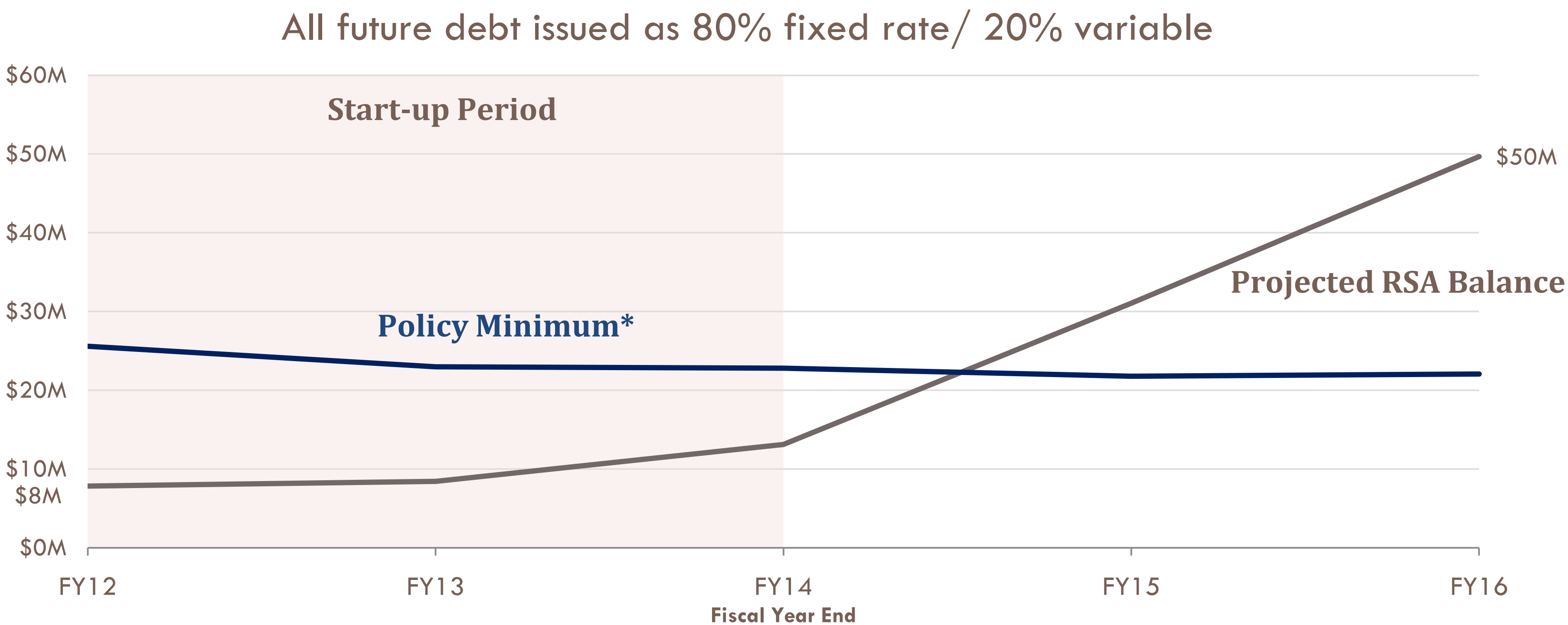


Portfolio Management:
Role of Variable Rate Debt

Higher levels of variable rate debt generate higher Rate Stabilization Account balances, but with a greater risk to University liquidity



Portfolio Management:
Rate Stabilization Account Ending Balance Example



	FY12	FY13	FY14	FY15	FY16
Rate Stabilization Account					
Ending Balance (in millions)	7.9	7.9	12.8	31.6	49.6
Policy Minimum*	25.6	23.0	22.8	21.8	22.1
Over/(Under) Policy Minimum	(17.7)	(15.1)	(10.0)	9.8	27.6

* Policy Minimum: The minimum balance of RSA sufficient to buffer against an increase in internal lending rate from a two standard deviation increase over the next two years

Managing Borrower Risk

ILP borrower's financial performance is compared to projections to detect potential loan repayment problems

	Monitoring	Reporting	Description
1.	Construction progress	Regents	Monitor project schedule and budget, ILP construction draws.
2.	Financial updates	Regents	Periodic updates (not less frequently than annual reports).
3.	Key financial metrics	Regents	Specific borrower financial data required by ILP financing agreements.
4.	Proforma variance	Internal	Annual variance review of proforma-vs.-actual financial performance.
5.	Minimum reserves	Internal	Semi-annual review of borrower reserves.

Portfolio Management: Borrower Impairment

(1) Monitoring

- Borrower is required to report key data annually.
- For major borrower, Treasury requires "early warning" quarterly or semi-annual reporting.

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(2) Mitigation

- Borrower is required to use internal resources to resolve financial issues.
- Internal resources include reserves, cost reductions, operating changes, revenue enhancements.

(3) Intervention

- If borrower is unable to fully mitigate problem, Provost will provide temporary bridge loan.
- Provost will require borrower's fullest internal mitigation efforts before providing assistance.

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(4) Restructure

- If borrower is unable to return to normal financial condition, operational and budgetary actions will be imposed.

Institutional Support

Internal borrower mitigation is undertaken before institutional resources are available

- ILP financing agreements identify institutional backstop if borrowers are unable to make debt service payments.
- Borrowers are required to take internal mitigation action before Provost provides loan backstop.
- Institutional backstop is a temporary bridge loan until normal financial condition is restored.

Appendix: Biographies of Asset Liability Management Advisory Committee Members

- **Ellen Evans, Deputy State Treasurer - Debt Management, State of Washington**

  Ms. Evans is responsible for managing all aspects of debt issuance by the State and participates in financial policymaking on a broad range of issues. Trained as an economist, her professional experience has been largely in institutional finance with Seattle-Northwest Securities, Salomon Brothers, the Federal Reserve Bank of New York and the United Nations. Additionally, she has taught at the Graduate School of Business at Columbia University and Seattle University. She earned graduate degrees in economics and international affairs at Columbia, and holds a BA from Middlebury College. She has served on the Board of Gage Academy of Art for eight years after taking a series of drawing classes. Ellen lives in Seattle with her husband Dr. Sandy Melzer and is the mother of two college-aged children.

- **Dean Torkelson, Senior Vice-President, Seattle-Northwest Securities**

  Mr. Torkelson joined Seattle-Northwest Securities in 1987 and served as President and CEO for eleven years. Since 1998, Mr. Torkelson has served as financial advisor to some of SNW's larger clients including the State of Washington (State Finance Committee) and the University of Washington. Mr. Torkelson began his finance career in municipal bond sales and trading and has also been active in fixed income portfolio management, public sector investment banking, and strategic planning. Prior to joining SNW, he was manager of the Capital Markets Division of Seattle-First National Bank and Treasurer of the bank and Seafirst Corporation. Mr. Torkelson has served as a Board member for the Municipal Securities Rulemaking Board and as an instructor at the Pacific Coast Banking School. He received his BA in Economics from Willamette University and his MBA from The Wharton School, University of Pennsylvania.

- **Bill Starkey, Vice-President, Seattle-Northwest Securities**

  Mr. Starkey has more than 12 years of experience in public finance and has represented Seattle-Northwest Securities as financial advisor to the University of Washington since 2006. His clients include the Oregon University System, the Ports of Portland and Seattle, the State of Washington, the City of Seattle, and King County. Mr. Starkey serves on SNW's credit committee and has worked on over 100 bond issues with a total par amount exceeding $14 billion. Prior to joining SNW, Mr. Starkey worked for the Washington State Department of Transportation, where he was responsible for debt management and financial planning. He received his Ph.D. degree in economics from the University of Washington and B.A. degrees in economics and psychology from the University of California at Santa Barbara. In addition to having taught college economics, Mr. Starkey is a FINRA Series 52 licensed municipal finance professional.