VII. STANDING COMMITTEES

B. Finance, Audit and Facilities Committee

Amendment to the Debt Management Policy and Implementation of the Internal Lending Program

RECOMMENDED ACTION:

It is the recommendation of the Administration and the Finance, Audit and Facilities Committee that the Board of Regents adopt the amended "Debt Management Policy: Statement of Objectives and Policies" to provide for the implementation of the Internal Lending Program.

BACKGROUND:

On September 19, 2002, the Board of Regents adopted the University's "Statement of Debt Policy." On July 16, 2004, the Board adopted an amendment to the University's debt policy appending an Interest Rate Swap Policy.

The proposed amendment to the current debt policy contains proposed changes to the University's internal financing and debt portfolio management practices that provide for implementation of the Internal Lending Program and are specifically aimed at lowering the institution's risk-adjusted cost of capital and providing internal borrowing units with a stable and predictable borrowing rate.

These proposed changes are part of a series of Treasury Office initiatives that will better integrate the management of the University's assets and liabilities to expand financial resources for funding strategic priorities. In addition to the debt management initiative, other Treasury Office initiatives include lowering cash balances to increase interest earnings and restructuring operating fund distributions for enhanced stability and predictability.

The proposed amendment to the current debt policy is structured in three sections: (1) the Internal Lending Program (ILP), (2) active management of the University's external debt portfolio, and (3) roles and responsibilities. The proposed policies are organized accordingly; the third section delineates the roles and responsibilities for key actions in the oversight and management of the University's internal financing and debt management functions.

1. Internal Lending Program (ILP)

Under current University financing practices, auxiliary borrowing is conducted directly with the external debt market as separate credits, or revenue pledges. Under the Internal Lending Program, auxiliaries will borrow directly from the ILP at a uniform internal lending rate that will be

B. Finance, Audit and Facilities Committee

Amendment to the Debt Management Policy and implementation of the Internal Lending Program (continued p.2)

available to all internal borrowing units. With the University's expanded local debt authority, the ILP will borrow from the external debt market using the University's General Revenue credit – ensuring the lowest risk-adjusted cost of capital for University borrowing.

The internal lending rate will reflect the University's blended cost of capital and will be supported by a rate stabilization reserve that will buffer internal borrowers from external interest rate volatility. The internal lending rate, which will cover ILP costs and fund a rate stabilization reserve, will be reviewed annually and will be subject to adjustment with the approval of the Board of Regents. The rate stabilization reserve will provide stability to the internal lending rate against external interest rate volatility and will be reviewed for sufficiency as part of the annual ILP fund review.

The ILP fund will receive debt service payments from internal borrowers and will fund external debt service payments. Withdrawals from the ILP fund for purposes other than ILP operation will require the approval of the Board and will be reported as part of the annual report to the Board. The annual report to the Board will also include a summary of the University's external debt portfolio and a request for approval of an annual debt issuance resolution for the upcoming year.

2. Active management of the University's external debt portfolio

The University's external debt portfolio will be actively managed to minimize the institution's risk-adjusted cost of capital over the long term and maintain the stability of the internal lending rate.

Active portfolio management will include the use of short-term and long-term borrowing, fixed interest rate and variable interest rate debt, amortizing and non-amortizing debt structures, financial derivatives, and both economic and strategic bond refundings. The University will enter into financial derivative transactions in accordance with the existing interest rate swap policy that was approved by the Board in 2004. The University will not enter into financial derivative transactions for speculative purposes.

The University will continue to maintain a minimum "A" category credit rating on its General Revenue obligations (as evaluated by Moody's and

B. Finance, Audit and Facilities Committee

Amendment to the Debt Management Policy and implementation of the Internal Lending Program (continued p.3)

Standard & Poor's rating services). Two core financial ratios will be used as performance benchmarks to evaluate institutional debt capacity. These ratios will be reported as part of the annual report to the Board of Regents on ILP and external debt portfolio management.

3. Roles and responsibilities

Major roles and responsibilities are summarized below:

| Item | Current | Proposed |
|---|---|---|
| | | |
| Debt management and swap policies | BOR approves | No change |
| Institutional credit rating standard | BOR approves | No change |
| Projects over $5 million (current BOR standing order) | BOR approves | No change |
| | | |
| (ILP) Exceptions to ILP participation | <New> | BOR approves |
| (ILP) Annual bond resolution | <New> | BOR approves |
| (ILP) Internal lending rate adjustment | <New> | BOR approves |
| (ILP) Exceptions to ILP fund policies | <New> | BOR approves |
| (ILP) Other ILP Fund withdrawals | <New> | BOR approves |
| | | |
| Bond counsel | BOR approves | SVPF&F approves |
| Financial services providers | BOR approves | SVPF&F approves |

REVIEW AND APPROVALS:

The Debt Management Policy recommendation was developed by the Treasury Office and reviewed by the President, Provost and Executive Vice President, Senior Vice President for Finance and Facilities, Office of Planning and Budgeting, and the University of Washington’s bond counsel and financial advisor, Seattle-Northwest Securities.

Attachments:
1. Debt Management Policy: Statement of Objectives and Policies
2. Interest Rate Swap Policy

**University of Washington**

**Debt Management Policy**

**Statement of Objectives and Policies**

Approved by the Board of Regents, September 19, 2002

Amended July 16, 2004 and May 15, 2008.

## Overview

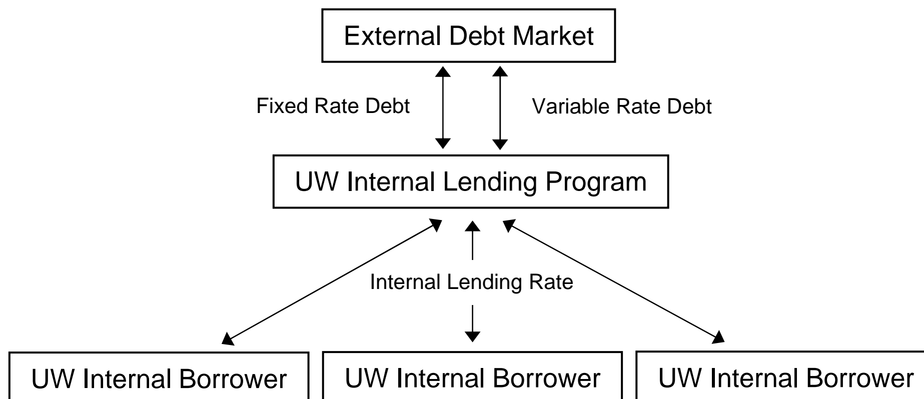
This statement of objectives and policies addresses the University's Internal Lending Program ("Program") and the active management of the institution's external debt portfolio.

The Internal Lending Program will make loans to internal borrowers at a uniform internal lending rate. These internal loans will be funded through the issuance of University General Revenue debt obligations.

The University's internal loan portfolio will be comprised of the outstanding loans to internal borrowers, while the insitution's external debt portfolio will be comprised of the institution's outstanding short-term and long-term debt obligations. The external debt portfolio will be actively managed to reduce the institution's cost of capital and to achieve stability and predictability in the internal lending rate. Active management of the external debt portfolio will entail the use of risk-evaluated debt structures and debt management techniques to achieve the lowest risk-adjusted cost of capital consistent with market conditions and institutional credit considerations.

The management of the Internal Lending Program and the external debt portfolio will be performed in accordance with policies set forth in this document and University debt management guidelines.

The diagram below outlines the relationship between the University's internal borrowers, the Internal Lending Program, and the external debt market:




This statement of objectives and policies includes:

A. Introduction. Statement of overall objectives, management, and reporting.

B. Internal Lending Program. Description of Program scope, loan categories, internal lending rate, loan agreement, and Program fund.

C. Debt portfolio management. Description of external debt portfolio management objectives, institutional credit rating, core financial benchmarks, debt structure, refunding bonds, and financial derivatives.

D. Roles and responsibilities. Description of roles and responsibilities relating to the management of the Program and the University's external debt portfolio.

## A. Introduction

1. Objectives. The primary objectives of the Internal Lending Program and active management of the University's external debt portfolio are to provide internal borrowers with access to funds at more stable and predictable interest rates and to reduce the institution's risk-adjusted cost of capital.

2. Management. The Program and the University's external debt portfolio will be managed by the Treasury Office under authority granted to the President by the Board of Regents.

3. Reporting. A report on the Program and the University's external debt portfolio will be presented annually to the Finance, Audit, and Facilities Committee of the Board of Regents.

## B. Internal Lending Program

The Internal Lending Program will make funds available to internal borrowers at a uniform interest rate that reflects the University's cost of capital.

1. Program scope. The Program will encompass all institutional financing needs, except as noted below. Alternative arrangements for any other financing action will require the approval of the Board of Regents.

   Financing actions exempted from participation in the Internal Lending Program:

   a. Debt repaid from appropriated University local funds (e.g., debt supported by Metro Tract revenue)

   b. Debt issued by an external entity on behalf of the University (e.g., 63-20, public-private, conduit financings)

   c. Personal property capital leases (e.g., equipment leases, equipment certificates of participation)

   d. Credit lines

2. Loan Types. Loan types for internal borrowing will include:

   a. Large capital expenditures (above $5 million). The approval of the Board of Regents will be required for capital expenditure loans exceeding $5 million. The maximum term of these loans will be 30 years (or the estimated useful life of the facilities).

   b. Small capital expenditures (less than $5 million). The approval of the Treasurer of the Board of Regents, will be required for capital expenditure loans up to $5 million. The maximum term of these loans will be 15 years (or the estimated useful life of the facilities).

   c. Operating loans. Short-term working capital loans up to $25 million and with a maximum term of two years will be available. Operating loans up to $5 million will require the approval of the Treasurer of the Board of Regents. Operating loans exceeding $5 million will require the approval of the Board of Regents. An additional 200 basis points (2.0 percent) above the prevailing internal lending rate will be charged on outstanding balances and a commitment fee of 10 basis points (0.10 percent) will be charged on any unused balance. The aggregate total of operating loan commitments will not exceed 30 percent of the University's commercial paper line of credit without the approval of the Treasurer of the Board of Regents.

3. Internal lending rate. An internal lending rate will be uniformly applied to all loans approved after Program implementation. The rate will reflect the external debt portfolio's weighted average interest rate and will include funding for Program operating costs and a rate stabilization reserve.

a. Rate adjustment. The internal lending rate will be reviewed annually and will be subject to adjustment by the Board of Regents. Any adjustment will comply with Program fund policies described in this document.

   Any preliminary indication of a rate adjustment will be announced to Program participants twelve months in advance of the effective date of the adjustment. Any formal proposal for a final rate adjustment will be announced to Program participants six months in advance of the effective date of the adjustment and updated internal repayment schedules reflecting the new rate will be distributed to Program participants within 45 days of this announcement.

b. Application. Adjustments to the internal lending rate will apply to all Program debt, including outstanding debt obligations incurred prior to Program implementation.

4. Program fund policies. Payments to the Internal Lending Program will be made monthly and held in a Program fund. External debt service payments will be made from the Program fund and all interest earnings will be retained in the Program fund. The Program fund will be managed according to the policies set forth below. Exceptions to these policies will require the approval of the Board of Regents.

   a. Operating level. The Program fund will be maintained at a level that enables the University to meet its Program obligations, including Program operating costs, debt portfolio management expenses, principal and interest on external debt, and a rate stabilization reserve maintained as described below. An accounting of Program fund activities will be included in the annual Program report to the Board of Regents.

   b. Rate stabilization reserve. The rate stabilization reserve will be managed to preserve the stability of the internal lending rate after considering forecasted external borrowing, changes in financial market conditions, and Program operating requirements. The minimum balance of the rate stabilization fund will be sufficient to buffer against an increase in the internal lending rate from a two standard deviation increase in the Municipal Market Data (MMD) long-term municipal bond rate or equivalent index over the next twenty-four months with an 80 percent confidence level.

   c. Program operating expenses. Program operating expenses, including the costs of staffing, facilities, equipment, supplies, and fees, will be paid from the Program fund.

   d. Loans funded from reserves. Program reserves may be used to fund internal loans.

   e. Debt portfolio management expenses. Expenses associated with actively managing the University's external debt portfolio, including the costs of debt issuance, loan restructuring, and financial derivative transactions, will be paid from the Program fund.

   f. Other University purposes. Withdrawals from the Program fund for University purposes other than those described in this section will require the approval of the Board of Regents. A list of Program fund withdrawals will be included in the annual Program report to the Board of Regents.

5. Internal financing agreement. An internal financing agreement describing the loan structure and repayment terms will be required for all loans. The loan agreement may also include the following:

   a. Borrower's financial condition and performance. Specific operating benchmarks to be achieved and/or maintained by the borrower during the term of the loan, which could include cash reserve targets and/or a plan of remediation for failure to comply with loan covenants.

   b. Reporting. Annual reviews and/or audits of the borrower's financial condition and performance, including identification of any changes in, or other factors relating to, facility occupancy or facility/equipment use that could affect the tax-related status of University debt.

## C. Debt Portfolio Management

The University's external debt portfolio will be actively managed to maintain the stability of the internal lending rate and to minimize the University's risk-adjusted cost of capital over the long term. The University will use

short-term and long-term fixed and variable interest rate debt obligations, bond refundings, and financial derivatives to achieve this goal within the following guidelines:

1. Objective. The objective of actively managing the University's external debt portfolio will be to achieve the lowest risk-adjusted cost of capital consistent with market conditions and credit rating parameters set forth below. Active management decisions will take into consideration relevant risks and terms that include, but are not limited to, market conditions, bond refunding savings, call options, variable interest rate bond remarketing and auction expenses, and liquidity, tax, and counterparty risks.

2. Portfolio Credit Standard. The University will manage its external debt portfolio to maintain a minimum "A" category credit rating on its General Revenue obligations as evaluated by Moody's Investors Service and Standard & Poor's rating agencies.

3. Debt structure. The University may issue fixed-rate, variable-rate, non-amortizing, and other forms of short-term and long-term debt to achieve its external debt portfolio management objectives.

4. Refunding bonds. The University may issue current and advance refunding bonds to lower or maintain the University's cost of capital over time. Refunding bonds will be issued to capture economic benefit and to restructure the debt portfolio in order to achieve longer-term strategic objectives.

5. Financial derivatives. The University may enter into financial derivative transactions to manage the institution's exposure to interest rate risk, reduce all-in borrowing costs of the external debt portfolio, and/or to manage other risks of the external debt portfolio that could adversely affect the internal lending rate or the Internal Lending Program. The University will enter into financial derivative transactions following guidelines in the University's Interest Rate Swap Policy. The University will not enter into financial derivative transactions for speculative purposes.

6. Core financial ratios. The University will use the following core financial ratios as performance benchmarks to evaluate institutional debt capacity. These ratios will be calculated and reported annually.

   a. Expendable resources-to-debt. Target range: 1.5 – 3.0 times. This balance sheet ratio measures the availability of unrestricted funds to cover all outstanding debt.

      Expendable Financial Resources*
      ----------------------------------------------
      Direct University Debt

   b. Debt service-to-operations. Target range: 2.5% – 5.0%. This statement-of-activities ratio measures the level of debt service on all outstanding debt as a percentage of overall operating expenses. (For non-amortizing bonds, principal will be assumed to be repaid in equal annual amounts).

      Peak Annual Debt Service*
      -------------------------------------
      Total Operating Expenses

   (*As defined by Moody's Investors Service)

**D. Roles and Responsibilities**

1. Board of Regents

   a. Approves policies that guide the operation of the Internal Lending Program and the management of the University's external debt portfolio
   b. Approves the annual bond resolution for the issuance of external debt
   c. Approves financing plans for loans above $5 million
   d. Delegates to the President the authority to enter into agreements to complete debt financing transactions above $5 million
   e. Approves exemptions of eligible financing transactions from participation in the Internal Lending Program

f. Approves the adjustment of the internal lending rate
g. Approves exceptions to Program fund policies

2. Finance, Audit, and Facilities Committee

    a. Recommends proposed financing actions to the Board of Regents
    b. Receives annual reports on the Internal Lending Program and the University's external debt portfolio

3. President

    a. Delegates authority to enter into agreements to complete debt financing transactions
    b. Delegates authority to approve loans up to $5 million

4. Treasurer of the Board of Regents

    a. Reviews all financing actions
    b. Approves loans up to $5 million (as delegated)
    c. Approves aggregate operating loan commitments that exceed 30 percent of the University's commercial paper line of credit
    d. Approves the selection of bond counsel, financial advisor, and other financial services providers

5. Senior Associate Treasurer

    a. Oversees the day-to-day activities of the University's Internal Lending Program
    b. Consults with the Attorney General's Office in the selection of bond counsel

## Appendix A
## Interest Rate Swap Policy
## July 16, 2004

**Introduction**

The purpose of the UW Debt Management Interest Rate Swap Policy (“Swap Policy”) is to establish guidelines for the execution and management of the UW interest rate swap program. This amendment to the UW Debt Management guidelines to incorporate this Swap Policy confirms the commitment of the Board, management, staff, advisors, and other decision makers to adhere to sound financial and risk management practices, including achieving the lowest possible cost of capital within prudent risk parameters.

**Philosophy Regarding Use of Swaps**

Interest rate swaps can be appropriate interest rate management tools. Properly used, swaps can increase the University’s financial flexibility, provide opportunities for interest rate savings, or reduce financial risk. Swaps will be integrated into the University’s overall debt management.

Interest Rate Swaps, and the related instruments detailed below, are used to accomplish the following:

- Reduce interest expense
- Hedge and actively manage interest rate, tax, basis, and other risks
- Optimize capital structure (e.g., achieve targeted debt allocation)
- Achieve appropriate asset/liability match

Permitted Instruments

The University may expressly use the following financial products after identifying the specific financial objective to be realized and assessing the attendant risks:

- Interest Rate Swaps – Immediate or forward starting floating-to-fixed rate swaps, designed to capture current market fixed interest rates or eliminate variable rate exposure. Fixed-to-floating rate swaps, designed to create additional variable interest rate exposure.
- Interest Rate Caps – Financial contracts (caps, collars, floors) which limit or bound exposure to interest rate volatility.
- Options on Swaps – Sales or purchases of options to commence or cancel interest rate swaps.
- Basis Swaps – Floating-to-floating rate swaps to manage basis or tax risk and change the basis on which variable cash flows are determined.
- Rate Locks – Often based on interest rate swaps, used to hedge an upcoming fixed rate bond issue.

The use of derivative financial products should produce a result not otherwise available in the debt market (lack of advance refunding/non-callable debt) or provide a higher level of savings, lower level of risk, greater flexibility, or other direct benefits.

The University may not use financial instruments that (i) create excessive leverage or financial risk; (ii) lack adequate liquidity to terminate at market; or (iii) provide insufficient price transparency to allow reasonable valuation.

**Swap Risk Analysis**

The University will evaluate all financial products with respect to the unique risks with which they are associated. A specific determination must be made that the expected benefits exceed the identified risks by an adequate margin over those available in the traditional debt market, if any.

For each transaction in isolation and in the context of all financial assets and liabilities, the University will perform a risk evaluation of the following factors:

- Market or interest rate risk – Does the transaction hedge or create interest rate volatility? By how much?
- Tax Risk – Is the transaction subject to a future change in federal income tax policy? If so, is the tax risk justified by expected benefits?
- Termination Risk – Under what circumstances might the transaction be terminated? What is the probable range of values? How would a possible termination payment be funded?
- Legal Risk – Is the transaction expressly authorized?
- Counterparty Risk – What is the creditworthiness of the counterparty? Is the transaction subject to future material change in counterparty creditworthiness?
- Rating Agency Risk – Is the proposed transaction consistent with current ratings?

- Basis Risk – Do the anticipated payments the University will receive match the payments it makes? If not, is the basis risk justified by the expected benefits?
- Amortization risk – Does the swap amortize in the same amounts and on the same schedule as the related bonds, and if not, what are the consequences of a mismatch, and how will this be handled?
- Rollover risk – If the swap terminates before the final term of the bonds, what is the range of results that could occur in entering into a new swap, and how will an adverse swap rate change be handled?
- Subsequent Business Conditions – Does the transaction or its benefits depend upon the continuation, or realization, of specific industry business conditions?

All swaps entered into by the University will be in compliance with RCW 39.96.

**Swap Procurement and Execution**

All services related to derivative financial products, including swaps, will be procured in a manner consistent with the University's standing practices for procuring investment banking and other services, so as to provide the University with the highest level of service at the best available terms and pricing.

The Board of Regents approval is required on all interest rate swaps. In the delegation of authority to undertake swaps the Board may also delegate discretion regarding future termination or modifications of the initial transactions provided the resulting structure is otherwise consistent with the Swap Policy (see Active Management, below).

Prior to execution of a swap or similar transaction, Financial Management Office will work with University accounting staff to ensure that all parties (borrowing department, Financial Management Office) have a clear understanding of the cash flow and reporting treatment of the proposed transaction.

**Swap Counterparties Policy**

The University shall execute credit-sensitive derivative transactions only with counterparties with strong credit ratings. The University shall do business with counterparties rated in the "AA" category or above as of the transaction date on a non-credit enhanced basis.

For lower-rated (below "AA" category) counterparties, the University shall require credit enhancement in the form of:

- Collateral
- Guarantees

Should the rating of the counterparty be below the "AA" category or the counterparty's rating be downgraded below the "AA" category, if its payment obligations are not guaranteed by another entity, or the entity that guarantees its payment obligations, if so secured, does not satisfy the requirements set forth above:

- The obligations of the Counterparty will be 102% collateralized by cash or Treasuries or Agencies; and
- The cash or obligations will be deposited with the University or with an agent of the University; and
- The collateral obligations will be valued daily.

The University will structure swap agreements to limit losses due to non-performance of its swap counterparties.

The University will establish and review counterparty exposure limits. (Not-to-exceed amounts for a given counterparty).

**Swap Documentation**

The University will use standard ISDA swap documentation, including the Schedule to the Master Agreement Credit Support Annex, and Confirmation. The University swap documentation will include the following features:

- Key provisions, including those related to early termination and collateral requirements.
- The specified indebtedness related to credit events in the Master Agreement will be narrowly drafted.
- Eligible collateral will be limited to Treasuries, Agencies, and cash.
- Collateral thresholds will be set on a sliding scale based on credit ratings.
- Termination value will be determined by "market quotation" methodology.
- A credit support annex will be used to document swap termination value collateralization procedures.

**Active Management**

The University will seek to maximize the benefits it accrues and minimize the risks it bears by actively managing its swap program. This will entail continuous monitoring of market conditions, in conjunction with the swap counterparty and the

University's advisors, for emergent opportunities and risks. Active management may entail modifications of existing positions including:

- Early termination
- Shortening or lengthening the term
- Sale or purchase of options
- Application of basis swaps

Each proposed modification must be consistent with this Swap Policy and be expected to further the goals of the swap program. The Financial Management Office will have limited yet sufficient flexibility to actively manage existing transactions without Board approvals.

**Reporting and Disclosure**

The Financial Management Office shall provide the Board of Regents with annual reports on the status of its swap and other derivative transactions in conjunction with annual debt management review. These reports will include market values, cash flows, value at risk and other performance measures, as well as evaluations of each transaction's performance relative to benchmarks or goals. The reports will also note all material changes to swap agreements.

The Financial Management Office will report to rating agencies periodically on the status of its swap and derivative transactions in conjunction with periodic updates on bond debt and debt management. The University shall ensure compliance with the Swap Policy as well as then-current accounting practices and federal, state, and local regulations and requirements.