VII. STANDING COMMITTEES

B. Finance and Asset Management Committee

Debt Management Annual Report

INFORMATION

The Board of Regents is charged with adopting the University’s Debt Management Policy, establishing the University’s credit standards, adopting the Annual Bond Resolution allowing for issuance of external debt, and approving the use of the Internal Lending Program to fund capital projects.

In addition, the Board is responsible for oversight of University debt outstanding, credit ratings, and compliance with bond covenants and IRS regulations. The Debt Management Annual Report provides the Board with a broad overview of the debt portfolio, the macro challenges, capital needs and interest rate environment that could affect the University’s credit rating, a summary of the Internal Lending Program, and recent accomplishments and future plans.

The Debt Management Annual Report does not require Regental action and is presented to provide the Board with information and context to allow the Board to make informed decisions about the University’s debt and internal lending activities.

Attachment
Debt Management Annual Report
University of Washington
Debt Management
Annual Report

BOARD OF REGENTS
FINANCE AND ASSET MANAGEMENT COMMITTEE
March 12, 2015
WHAT IS THE BOARD OF REGENTS’ ROLE IN DEBT MANAGEMENT?

The debt management annual report informs the Board in its oversight role.

The Board of Regents are responsible for the following:

- **Board Oversight**
  - Guide University credit standards
  - Oversee debt outstanding, credit ratings, and compliance with bond covenants and IRS regulations

- **Board Action**
  - Adopt the debt policy
  - Adopt bond resolutions to allow for issuance of external debt
  - Approve Internal Lending Program (ILP) Loans
  - Establish ILP interest rate and rate stabilization account distributions
WHAT IS THE UW’S DEBT PROFILE FOR 2015?
(in millions as of March 12, 2015)

The University’s debt portfolio consists primarily of fixed rate debt.

Overview

- Only $50 million of variable rate outstanding (2%)
- Average borrowing rate for the portfolio is 3.8%
- Between $60 and $80 million in principal is repaid annually
- There are approximately $368 million in authorized projects remaining to be funded over the next four years
  - ILP Projects: $316 million
  - Non-ILP Projects: $52 million

Maximum Annual Debt Service: $178M

UW Outstanding Debt by Type
Total Debt: $2,181

- General Revenue Bonds, $1,480
- State Issued Bonds, Payable by UW, $171
- Lease Revenue Bonds, $289
- Other, $25
- CP, $50
- NWH, $86
- VMC (2), $80

(1) Excludes Commercial Paper Principal Payments
(2) Excludes Valley LTGO Bonds
HOW DID THE MOST RECENT BOND ISSUE IMPACT INSTITUTIONAL RISK?

A large payment due in 2037 was reduced to lower both borrowing cost and institutional risk.

$218m in General Revenue Bonds were issued in January to refund three series of bonds and finance Metro Tract improvements

– Debt service payments through 2036 are $75 million lower
– All-in interest rate of 3.2%

Debt service was restructured to reduce institutional risk

– Earlier principal payments reduced borrowing costs and increased savings
– More principal payments in the early years allows for future borrowing flexibility
– The payment in 2037 is now $98 million lower
HOW HAS UW’S CREDIT RATING CHANGED OVER TIME?

In January 2015, S&P changed the University’s outlook from positive to stable.

### Agency Credit Rating by Year

<table>
<thead>
<tr>
<th>Year</th>
<th>Moody's Scale</th>
<th>S&amp;P's Scale</th>
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</thead>
<tbody>
<tr>
<td>2004</td>
<td>Aaa stable</td>
<td>AAA stable</td>
</tr>
<tr>
<td>2005</td>
<td>Aaa negative</td>
<td>AAA negative</td>
</tr>
<tr>
<td>2006</td>
<td>Aa1 positive</td>
<td>AA+ positive</td>
</tr>
<tr>
<td>2007</td>
<td>Aa1 stable</td>
<td>AA+ stable</td>
</tr>
<tr>
<td>2008</td>
<td>Aa1 negative</td>
<td>AA+ negative</td>
</tr>
<tr>
<td>2009</td>
<td></td>
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<td>2010</td>
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<td>2011</td>
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<td>2014</td>
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<tr>
<td>2015</td>
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</tbody>
</table>

**Reasons for the recent outlook change include:**
- Continued uncertainty surrounding State support
- Expectations that operating margins at UW Medicine will continue to face pressure

**The change in outlook:**
- Occurred even though the debt burden did not increase
- Did not have a measurable impact on borrowing cost

**UW estimates debt capacity based on financial ratios associated with peer group:**
- Tradeoff between institutional mission and credit rating / borrowing cost
HOW FINANCIALLY HEALTHY IS THE UW?

The University has maintained its Aaa rating through steady research, healthcare and educational revenues.

In 2014, expendable financial resources could pay outstanding debt 1.6 times, slightly higher than 2013 primarily due to an increase in restricted expendable assets.

In 2014, net revenues were 2.9 times higher than annual debt service. The decrease from 2013 was due to an increase in debt service payments and a decrease in adjusted operating income.

In 2014, total outstanding debt was 50% of operating revenues, which is unchanged from 2013.
WHICH UNIVERSITIES ARE IN THE UW’S PEER GROUP?

The University’s peer group is comprised of 13 institutions:

Ohio State University  
Pennsylvania State University  
University of Iowa  
University of Alabama at Birmingham  
University of Arkansas  
University of Colorado  
University of Kentucky  
University of Michigan  
University of Nebraska  
University of New Mexico  
University of North Carolina at Chapel Hill  
University of Utah  
University of Virginia  
University of Washington

These universities meet the following criteria:

– All public universities rated Aa2 or higher by Moody’s
– Patient care revenue greater than 10% of total revenues
– Total revenue greater than $1 billion
– No state-wide “systems”
WHAT HAS BEEN THE COST OF UW DEBT OVER THE LAST 5 YEARS?

S&P’s recent outlook change from “positive” to “stable” had no measurable impact on borrowing cost.

Oct-10, $150m with an interest cost of 3.2%
Dec-10, $150m with an interest cost of 4.0%
Jul-11, $211m with an interest cost of 3.9%
Mar-12, $268m with an interest cost of 3.7%
Dec-12, $300m with an interest cost of 3.0%
Sep-13, $146m with an interest cost of 4.5%
Aug-14, $115m with an interest cost of 3.4%
Jan-14, $29m with an interest cost of 3.9%
Jan-15, $218m with an interest cost of 3.2%
WHAT IS THE OUTLOOK FOR UW?

All of public higher education face financial challenges, but prudent capital investments can help UW manage these uncertainties into the future.

Macro challenges

- Uncertainty in health care presents challenges to universities with academic medical centers
- Budget challenges at the State level could pose financial risk to the University
- Uncertainty surrounding the amount and timing of federal funding persists, including Medicare and Medicaid, Pell Grants, research funding
- Limited willingness to raise tuition reduces financial flexibility

Interest rates are attractive for high grade issuers

- Long and short term rates remain near historic lows
- The difference between short-term and long-term rates is wide
- A narrow relationship exists between tax-exempt and taxable rates

The University’s ambitious capital plan exceeds ability to fund projects

- The FY14 One Capital Plan showed $6 billion of projects through 2024, with $2 billion coming from debt
- Increasing amount of debt has pressured credit ratings and could increase borrowing cost
- Higher debt service reduces financial flexibility and ability to withstand shocks
- Funding deferred maintenance remains challenging
- Thoughtful capital planning and careful debt management are positive factors
- The creation and use of the Capital Assets Pool partially mitigates the negative financial impact of funding projects
WHAT ARE THE REQUIRED COVENANTS FOR INTERNAL BORROWERS?

The creation of the General Revenue Bond platform and Internal Lending Program allowed the University to move away from externally imposed bond covenants.

- Financing agreements between the Treasury Office and internal borrowers impose fiscal discipline previously required by the external market
  - Debt service coverage and minimum reserve levels
  - Audited financial statements or revenue and expense summary
- Large borrowers report semi-annually to the Board, demonstrating proforma and actual results
- If covenants are not met, the department identifies and implements mitigation strategies

### ILP Loan Portfolio by Borrower ($)

<table>
<thead>
<tr>
<th>Department</th>
<th>Loan Balance ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Housing and Food Services</td>
<td>485.2</td>
</tr>
<tr>
<td>Central Administration</td>
<td>315.4</td>
</tr>
<tr>
<td>Intercollegiate Athletics</td>
<td>257.6</td>
</tr>
<tr>
<td>UW Medicine</td>
<td>233.8</td>
</tr>
<tr>
<td>Student Life</td>
<td>151.6</td>
</tr>
<tr>
<td>Real Estate</td>
<td>33.1</td>
</tr>
<tr>
<td>UW Bothell</td>
<td>15.7</td>
</tr>
<tr>
<td>UW Tacoma</td>
<td>15.3</td>
</tr>
<tr>
<td>Transportation Services</td>
<td>13.5</td>
</tr>
<tr>
<td>School of Dentistry</td>
<td>10.8</td>
</tr>
<tr>
<td>School of Global Health</td>
<td>1.7</td>
</tr>
<tr>
<td><strong>Total Outstanding 12/31/2014</strong></td>
<td><strong>1,533.9</strong></td>
</tr>
</tbody>
</table>

### ILP Loan Portfolio by Borrower (%)

- Housing and Food Services: 31.6%
- Central Administration: 15.2%
- Intercollegiate Athletics: 16.8%
- UW Medicine: 20.6%
- Student Life: 9.9%
- Other: 5.9%
HOW DOES THE INTERNAL LENDING PROGRAM WORK?

The ILP was created to provide a stable, long term interest rate to campus borrowers.

- Portfolio management (e.g. use of variable rate, borrow as funds are needed) can lower institutional borrowing costs
- The difference between external borrowing costs and interest collected contributes to the Rate Stabilization Account (RSA)
- The RSA is used to maintain a stable internal rate as external borrowing rates increase
- Sufficiency of the RSA is reviewed annually
The Rate Stabilization Account is sufficient for about 6 years at the new internal rate of 4.75%. No rate change is recommended at this time.

- The role of the Rate Stabilization Account (RSA) is to protect the University against rising interest rates. The larger the RSA balance, the more protection against having to raise the internal rate.
- Sufficiency is the amount needed in the RSA today to hold the internal rate stable for a period of time. It is calculated for 5, 10 and 30 years.
- Each year, the RSA sufficiency is recalculated based on interest rate scenarios and borrowing plans.
- Recent low interest rates have contributed to the RSA balance, but continued need for debt funding in a rising rate environment would put pressure on the RSA.
- Approval of the Capital Assets Pool reduced borrowing by over $200 million, mitigating rate risk to the RSA.

### Stress Case at 4.75% Internal Lending (6 years sufficiency)

<table>
<thead>
<tr>
<th>Length of Stable ILP Rate</th>
<th>2015 - 2019</th>
<th>2020 - 2029</th>
<th>2030 - 2044</th>
</tr>
</thead>
<tbody>
<tr>
<td>Borrowing Rate and Amount Assumptions for Stress Case</td>
<td>Borrowing Rates: 5.50% - 6.50%</td>
<td>Borrowing Rates: 6.75% - 6.10%</td>
<td>Borrowing Rates: 6.10%</td>
</tr>
<tr>
<td></td>
<td>Additional Borrowing: $811M</td>
<td>Additional Borrowing: $500M</td>
<td>Additional Borrowing: $2.1B</td>
</tr>
<tr>
<td>Sufficiency Balance Required Today</td>
<td>$0</td>
<td>$4M</td>
<td>$75M</td>
</tr>
<tr>
<td></td>
<td>underfunded</td>
<td>sufficiency range</td>
<td>overfunded</td>
</tr>
<tr>
<td>Today</td>
<td>2019</td>
<td>2024</td>
<td>2044</td>
</tr>
<tr>
<td>Projected 6/15 Balance: $44M</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* Borrow to One Capital Plan through year 5. Years 6-30 reflect debt capacity recapture due to repayments.
WHAT ARE SOME RECENT ACCOMPLISHMENTS?

Key accomplishments included a restructure of the debt portfolio and the introduction of two new programs.

**Issuance**
- Sold $115 million of Lease Revenue Bonds in July 2014 at an interest rate of 3.39%
  - Bonds refunded debt issued to support South Lake Union Phase 2
  - Total debt service (through FY2038) was reduced by $15 million
- Sold $218.27 million of General Revenue Bonds in January 2015 at an interest rate of 3.19%
  - Bonds were issued to pay off $42.5 million of commercial paper for the Metro Tract and to refinance bonds that were used to purchase the UW Tower in 2008, the IMA in 2000, and the 4545 Building in 2006
  - Debt service was restructured to lower borrowing cost and reduce institutional risk
  - Total debt service (through 2037) was reduced by $75 million

**Disclosure**
- Semi-Annual Borrower Reports provide ongoing review of largest borrowers for Board
- Combined ILP Quarterly with Semi-Annual Borrower Reports into the Semi-Annual Debt Report. This report provides a portfolio and borrower overview

**Program Development**
- In FY14, the Board of Regents approved the creation of the Capital Assets Pool (CAP) to fund projects
  - The CAP was created to reduce external borrowing for approved projects
  - Program sized to 10% of the Invested Funds (~$227m as of 6/30/2014)
  - Projected CAP allocation for FY15 is ~$120 million
- In FY15 the Treasury Office implemented a new program to finance short-term assets more efficiently
HOW ARE SHORT-TERM ASSETS FINANCED AT THE UW?

The University implemented a program to efficiently finance short-term assets.

Historically, short-term assets have been financed using:
- State Certificates of Participation
- One-off leases

New “FAST” program offers potentially better alternative:
- “FAST” stands for Financing Assets Short-Term
- JP Morgan Chase developed a customized product to meet University needs

Characteristics of this program include:
- Program size of $12 million
- 3 – 10 year amortization at highly competitive fixed rates
- Have already provided loans to 2 internal borrowers
  - $5.2 million to replace IT servers; 3-year tax-exempt loan at 1.2%
  - $1 million to fund project in Suzzallo Library; 10-year tax-exempt loan at 2.2%
  - $5.8 million of remaining authorization

Why FAST was established?
- Reduce need for “one-off” lease financings
- Better match useful life of asset to borrowing costs
- Potential for faster funding (can now provide funds within one month of request)
- Centralize oversight of short term loans
- Eliminate collateralizing of university assets during financing term

As demand increases, the Board may be asked to increase program size
- Current program authorized under existing Board delegation
WHAT ARE THE CURRENT INITIATIVES?

Current initiatives are focused on liquidity needs and debt issuance.

Optimization of the CAP program
- Examine liquidity levels to right-size CAP program
- Use of CAP program mitigates the need for external borrowing

Debt Issuance
- Issue fixed-rate debt for HR payroll to mitigate interest rate risk to campus
- Continue to look for ways to lower institutional borrowing cost
  - Increase variable rate exposure to target levels over time
  - Seek refunding opportunities

Continue to improve policies and procedures surrounding private use