STANDING COMMITTEES

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, establishing the Internal Lending Rate, 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

May 12, 2016
AGENDA

1. Portfolio Overview
2. Institutional Risk
3. ILP Rate Recommendation
4. Project Capacity
5. Accomplishments
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 and use of CAP
- Approve Internal Lending Program (ILP) Loans
- Establish ILP interest rate and rate stabilization account distributions

Diagram:
- **Board Oversight**
  - Strategic Planning
  - Review Debt Capacity
  - Adopt Debt Policies

- **Portfolio**
  - Portfolio Structure
  - Review Portfolio Performance
  - Approve ILP Rate

- **Project**
  - Debt Issuance
  - Review SABRE
  - Authorize Debt Issuance
  - Fund
  - Service Internal Loans
  - Project Due Diligence
  - Approve ILP Loans
  - Approve Financial Stability Plans
The University’s borrowing rate is impacted by a variety of factors including term, debt type, tax status, couponing, etc.

While short-term rates remain extremely low, recent increases have occurred due to liquidation of some money market funds and money market reform.

The University issued $327 million in FY 2016 and had another $430 million of debt funded projects approved by the Board of Regents.
The University has a large and conservative debt portfolio

- The debt portfolio consists primarily of fixed rate debt ($50 million of variable rate debt)
- Average borrowing rate for portfolio is 3.55%
- There is approximately $430 million in authorized debt remaining to be issued over the next four years
- Approximately $80-$100 million of principal is repaid annually
- More than 70% of debt has been issued as General Revenue Bonds

Outstanding Debt by Type
Total Debt: $2,356
(In millions as of March 31st, 2016)

- General Revenue Bonds, $1,638, 70%
- State Issued Bonds, Payable by UW, $147, 7%
- Lease Revenue Bonds, $408, 17%
- Other, $21, 1%
- NWH, $12, 1%
- Valley, $79, 3%

Maximum annual debt service: $204m in FY18

1) Excludes principal payments on Commercial Paper
2) Excludes Valley Medical Center Limited Tax General Obligation Bonds

TREASURY OFFICE
UNIVERSITY of WASHINGTON

F–3.1/205-16
5/12/16
CREDIT OVERVIEW

The University’s ratings remain stable at Aaa/AA+ (Moody's/S&P). Increased borrowing and declining metrics will put downward pressure on the University’s ratings.

<table>
<thead>
<tr>
<th>Credit Strengths</th>
<th>Credit Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; Strong market position</td>
<td>&gt; Increasing leverage, debt issuance outpacing growth of financial resources and revenues</td>
</tr>
<tr>
<td>&gt; Significant national research profile, good student demand, major clinical care provider for the Pacific Northwest</td>
<td>&gt; Slowing growth in net tuition revenues with the state reassuming full tuition setting authority for in-state undergraduate tuition</td>
</tr>
<tr>
<td>&gt; Good financial flexibility with $1.6 billion of unrestricted financial resources</td>
<td>&gt; Increasingly competitive research funding environment</td>
</tr>
<tr>
<td>&gt; Consistently favorable operations</td>
<td>&gt; Significant healthcare exposure with lower margins and liquidity</td>
</tr>
<tr>
<td>&gt; Integrated planning, active debt and project management, and very good disclosure</td>
<td></td>
</tr>
</tbody>
</table>

Macro challenges

> Uncertainty in health care presents challenges to universities with academic medical centers
> Budget challenges at the State level could pose financial risk
> Increasingly competitive research funding environment

Interest rates remain attractive for high grade issuers, however short-term rates are beginning to rise

> Recent increases have occurred due to liquidation of some money market funds and money market reform
### INSTITUTIONAL RISK

Each project creates institutional credit risk

- Central administration guarantees all loans
- Each borrower has a different risk profile
- Borrowers benefit from the ILP through lower borrowing cost

<table>
<thead>
<tr>
<th>Less Risky</th>
<th>More Risky</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt; Demonstrated demand for the project</td>
<td>&gt; Demand is based on projections, growth, and/or assumed behavior</td>
</tr>
<tr>
<td>&gt; Pre-determined and reliable revenue stream (i.e. student fees)</td>
<td>&gt; Variable or uncertain revenues</td>
</tr>
<tr>
<td>&gt; Diverse revenue stream</td>
<td>&gt; Singular revenue stream</td>
</tr>
<tr>
<td>&gt; Predictable and controllable expenses</td>
<td>&gt; Variable or unknown expenses</td>
</tr>
<tr>
<td>&gt; Control over major revenues and expenses</td>
<td>&gt; Regulations or changing business landscape that impacts financial performance</td>
</tr>
<tr>
<td>&gt; Strong financial metrics aided by project equity</td>
<td>&gt; Weak financial metrics with little or no equity</td>
</tr>
<tr>
<td>&gt; Ability to withstand financial stress</td>
<td>&gt; Inability to withstand financial stress</td>
</tr>
</tbody>
</table>
DUE DILIGENCE PROCESS

The current process focuses on affordability and ongoing disclosure

Initial financial due diligence
- Develop financial strategy with borrowers
- Identify and stress potential risks
- Establish financial covenants (i.e. reserve levels and debt service coverage)

Ongoing continuing disclosure
- Financial audits required for borrowers
- Semi-Annual Borrower Reports provide financial health updates

Financial Stability Plans (FSP)
- Board policy requires that each borrower bring a FSP if financial covenants are not met
- Treasury and Planning and Management work with the borrower to identify and communicate financial solutions
- FSP approval resets the financial proforma
DUE DILIGENCE PROCESS

New risk mitigation strategies are being implemented as part of continuing policy and program refinement

On an institutional level
> Pledging general revenues lowers external borrowing cost but transfers risk to central administration
  > A portion of the ILP rate (0.15%) partially compensates central administration for the additional risk

On a unit level
> Project equity reduces financial risk and helps align stakeholders
  > Provide a minimum of 25% equity
> Financial proformas need to be able to withstand unexpected variances in revenues and/or expenses
The Rate Stabilization Account (RSA) is used to maintain a stable internal rate with the reserve balance buffering the internal rate when external rates rise. The difference between external and internal rates stays in the RSA.

The Program Fund is one account that enables the ILP to meet its obligations including operating costs, debt management expenses, external debt service payments, unspent bond proceeds and rate stabilization. Funds can also be spent on approved capital projects.

Arises from non-amortizing debt, original issue premium and savings from debt refundings.

The Invested Funds (IF) is an investment pool consisting of the University’s operating funds. The Capital Assets Pool (CAP) is sized to 10% of the IF and is used to fund capital projects.
Treasury analyzes the Program Fund each year and rebalances as necessary

- The Program Fund is composed of the RSA and Residual Account (includes unspent bond proceeds, interest earnings, debt service timing differences and Original Issue Premium)
- Any funds not needed to make current and future debt service payments or fund projects can be used for rate stabilization
- As part of this year’s rebalancing, Treasury will allocate $30 million to the RSA (as a result of non-amortizing debt, original issue premium and savings from debt refundings) from the Residual Account
- After this allocation, the RSA is projected to be $80 million at the end of FY2016
The market determines external interest rates (e.g. 4% market rate)

Under certain market conditions investors are willing to pay up-front for a higher return over time (e.g. 5% issue rate)

This payment means that the ILP receives more money from internal borrowers than it owes to investors

This creates an imbalance between the RSA and Residual Account over time

Treasury reviews the Program Fund annually

A hypothetical Original Issue Premium example demonstrates the rationale for rebalancing

The ILP lends $110m at the ILP rate

ILP collects $110m from campus borrowers

UW repays $100m to the external market

$10m flows into the Residual Account over time

UW borrows $100m in par value of bonds

4% Market Rate

5% Issue Rate

$10m of original issue premium

Total proceeds = $110m

Original Issue Premium Example

F–3.1/205-16
5/12/16
ALM reviews account balances and projections annually as part of its ILP rate setting recommendation to the Board

- The ILP rate was established in 2008 at 5.50%. It was chosen based on a long term (100 year) average of interest rates, plus 50 basis points (0.50%) to allow for future rate increases. A sustained period of borrowing at low interest rates enabled a reduction to the ILP rate to 4.75% in 2015
- Sufficiency is the amount needed in the RSA today to hold the internal rate stable for a period of time. The RSA is sufficient for 8 years with the new internal rate
- Each year RSA sufficiency and allocation is assessed based on interest rate scenarios and borrowing plans
- Recent low interest rates have contributed to the RSA balance, but the need for debt funding in a rising rate environment would put pressure on the RSA

<table>
<thead>
<tr>
<th>Stress Case at 4.50% Lending (8 years sufficiency)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Borrowing Rate and Amount Assumptions for Stress Case</strong></td>
</tr>
<tr>
<td>2016-2021</td>
</tr>
<tr>
<td>Borrowing Rates: 4.38%-6.48%</td>
</tr>
<tr>
<td>Additional Borrowing: $760m</td>
</tr>
<tr>
<td><strong>Length of Stable ILP Rate</strong></td>
</tr>
<tr>
<td>Today</td>
</tr>
<tr>
<td>Underfunded</td>
</tr>
<tr>
<td>$0</td>
</tr>
<tr>
<td><strong>Sufficiency Balance Required Today (millions)</strong></td>
</tr>
<tr>
<td>Today</td>
</tr>
<tr>
<td>Underfunded</td>
</tr>
<tr>
<td>$0</td>
</tr>
</tbody>
</table>
Internal Lending Program

Campus Borrowers

- Interest Payments, 4.50%
- Principal Payments

Program Support Allocation, 0.10%
General Revenue Support Allocation, 0.15%

Rate Stabilization Account\(^{(1)}\)
~$80m

Program Fund\(^{(2)}\)

Residual Account
~$170m

Rebalance\(^{(3)}\)

External Lenders and Capital Assets Pool\(^{(4)}\)
- Bond Proceeds
- Debt Service Payments, 3.60%
- CAP Funding

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INSTITUTIONAL PROJECT CAPACITY

The University takes a comprehensive and analytical approach in assessing its ability to finance projects

> Annually the University projects revenues and expenses over a five year period and derives institutional debt capacity
> Debt capacity (which excludes CAP) measures how much debt the University can issue while staying at or above peer minimums in three ratios. The three ratios are:
  > Debt Service Coverage
  > Debt to Operating Revenue
  > Expendable Financial Resources to Debt*
> Institutional project capacity is calculated by adding together debt capacity and available CAP
> The peer group was put together based on several criteria:
  > All public schools, Aa2 and higher
  > Schools generating $1B+ in revenue
  > Schools with more than 10% of their revenues generated from health care
  > Excludes ‘state-wide’ systems

The University’s peer group is currently 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

*Moody’s modifying ratio calculation
INSTITUTIONAL PROJECT CAPACITY

Many factors influence institutional project capacity

Within the University’s influence

> **Principal repayment**: In FY 2017, the University will pay $83 million in principal. Repaying debt increases institutional project capacity

> **Project approval**: Approving projects decreases institutional project capacity. The Board approved $470 million of projects in FY 2016

> **Growth**: Growth in net operating income improves financial ratios and increases institutional project capacity. The University’s operating income was relatively flat in 2015 as compared to 2014

> **Use of institutional funds**: CAP allows projects to be funded without external borrowing. The CAP limit is 10% of the Invested Funds (IF), which changes as the value of the IF changes. The IF value has decreased this year which has decreased institutional project capacity

Outside the University’s influence

> **Changes in peer behavior**: The University estimates institutional project capacity based on peer medians. Peer behavior can either increase or decrease institutional project capacity. Over the last year, the peer minimum for debt service coverage declined by roughly 5%. This change had a positive effect on debt capacity

> **Interest rates**: Future increases in interest rates decrease institutional project capacity. Long-term rates in 2016 remained low, however recently there has been a small uptick in short term rates
**INSTITUTIONAL PROJECT CAPACITY**

~$425 million of non-cash funded projects can be approved in the next 5 years

5 Year Project Capacity: 2017-2021 (in millions)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Debt Capacity</td>
<td>$755</td>
</tr>
<tr>
<td>Plus: Remaining CAP</td>
<td>100</td>
</tr>
<tr>
<td><strong>Total Institutional Project Capacity</strong></td>
<td>855</td>
</tr>
<tr>
<td>Less: Authorized Projects</td>
<td>(430)</td>
</tr>
<tr>
<td><strong>Remaining Project Capacity</strong></td>
<td>$425</td>
</tr>
</tbody>
</table>

(1) Not inclusive of current outstanding debt. Figures represent how much additional debt the University can issue over the next five years.

(2) 10% of the Invested Funds (IF) less previously allocated CAP dollars. Based on current IF value.

(3) Includes Life Sciences, Housing Phase 4a and other authorized projects. Approximately $430 million of debt needs to be issued for authorized projects after the September 2015 General Revenue Bonds issue.
ACCOMPLISHMENTS

Campus partnerships
> **Financial Forecasting Refinement**: Collaboration between units led to a more robust planning tool
> **Debt capacity and One Capital Plan integration**: Worked with Capital Planning and Development to link capital planning with debt capacity
> **Financial Stability Plan**: Provide financial expertise, consistent communication and solutions for borrowers not meeting covenants

Student engagement
> **Junior Analyst program**: New program hires recent University graduates
> **Direct student interactions**: Examples include guest lecturing in classes and groups, student board presentations, and working with student fee committees

Program development
> **Financing Assets in the Short Term (FAST) implementation**: Demand for FAST product currently exceeds capacity
> **Compliance enhancement**: Improved policies and procedures help ensure post-issuance compliance and measurement of private business use