Subject: **Institutional Debt**

PURPOSE

To define institutional policy and associated issues related to issuance and management of long-term debt.

POLICY

I. Purposes and objectives of issuing debt

The power and ability to borrow when necessary on the most favorable terms is one of the institution's most useful and important strategic capabilities. Financial leverage enables the University to grow its academic, research, and service capabilities and is considered a long-term component of the balance sheet. Debt, especially tax exempt debt, provides an efficient and low-cost source of capital for the University. Debt financing allows the institution to pay for an asset over a period of time, matching the payment stream against the approximate useful economic life of the asset.

This Debt Policy provides a framework by which decisions are made concerning the use and management of debt. Along with the annual operating budget and capital plan, this policy forms a comprehensive financial planning and monitoring model that can be used in effecting the University's strategic initiatives.

A. Manage the University's credit to meet its strategic objectives

1. Capital planning

The University recognizes that its campus facilities need to keep pace with programmatic expansion. The long-term strategic planning process establishes institutional goals, priorities and initiatives - which define capital investment requirements. The University will utilize a mix of financing sources including state appropriations, reimbursed overhead, donations/endowment income (if permitted under the gift agreement), other current income, internal reserves, <u>and debt</u> to fund these capital investments.

2. Credit ratings

The University seeks to maintain its creditworthiness and the most favorable relative cost of capital and borrowing terms. By maintaining a high credit rating, the University will be able to continue to issue debt and finance capital projects at favorable interest rates. The University will limit its overall debt to a level that, when viewed in the context of its current and future strategic objectives, is the most advantageous for its financial strength over the long-term.

B. Optimize the debt portfolio

1. Access to capital

Management may utilize and issue debt in order to ensure timely access to capital.

2. Limit risk

Debt will be managed on a portfolio, rather than a transactional or project-specific basis. The University's continuing objective of incurring the lowest achievable risk-adjusted cost of capital will be balanced with the goal of appropriately balancing exposure to market shifts and other risks associated with the debt portfolio.

C. Establish criteria to monitor debt capacity

The University will establish meaningful measures, including ratios and coverages, to ensure it continues to operate within generally accepted financial parameters and to enable it to maintain and/or improve its credit rating as determined by the rating agencies.

II. Types of debt instruments

The University will review all potential funding sources for projects, recognizing that there are numerous financing structures and funding sources, each with specific benefits, risks, and costs. The University will obtain outside professional advice as necessary to identify and evaluate financing alternatives and opportunities. All potential funding sources will be reviewed within the context of this debt policy and the overall portfolio to ensure that chosen financial products or structures are consistent with the University's objectives. Regardless of which financing structures are utilized, a comprehensive analysis of the transaction will be completed, including quantifying potential risks and benefits and the impact on creditworthiness and debt capacity as indicated in this debt policy.

A. Revenue Bonds

Revenue bonds carry a promise to repay from an identified revenue source or sources. The University typically uses revenue bonds for the bulk of its long-term debt needs. Three separate bond systems – each having its own revenue stream pledge – have been developed to address the different groupings of capital projects undertaken by the University.

1. Auxiliary & Campus Facilities System – this system is used for funding construction or renovation of facilities housing auxiliary enterprises and related functions. The net revenues of such enterprises are pledged for the retirement of outstanding long-term debt.
2. Hospital Facilities System – this system is used for funding construction or renovation of facilities housing health care delivery and support services. Net hospital system revenues are pledged for the retirement of outstanding long-term debt.
3. Research Facilities System – this system is used for funding construction or renovation of facilities housing basic and applied research functions. Indirect cost recovery revenues from federal government and other research sponsors are pledged for the retirement of outstanding long-term debt.

B. Capitalized lease obligations

In accordance with Statement of Financial Accounting Standards No. 13, a lease is a financing transaction called a capital lease if it meets any one of four specified criteria. If not, it is an operating lease. Capital leases are treated as the acquisition of assets and the incurrence of obligations by the lessee.

C. Other

Other debt instruments, such as Certificates of Participation (COPs), off-balance sheet financings and third-party debt may be considered in financing capital construction, renovation, or equipment purchase – where the situation makes economic sense given the facts and circumstances inherent in the particular financing.

III. Debt structuring

A. Issuance size and timing

Debt financings will be coordinated to the extent practical so that multiple project needs can be accommodated in a single borrowing, thereby increasing the efficiency of the debt issuance. Since many issuance costs do not vary with the size of a borrowing, a multi-purpose bond issue increases the efficiency of the financing by spreading fixed costs over a greater number of projects.

B. Par amount

The par amount of bonds sold will ordinarily be adjusted to cover the following costs beyond the capital project needs: bond issuance costs, underwriters' discount, original issue discount/premium, debt service reserves, and capitalized interest.

C. Financing considerations

1. The University, in conjuction with its financial advisor, will consider specific strategies currently applicable for keeping its financing costs low as part of its preparations for each new debt issuance or refinancing.
2. Maturity/amortization
   The overall maturity should generally not exceed the useful life of the financial asset, and may never exceed 120% of the useful life of the financed asset. Useful economic life will be determined by the University's depreciation policy. Maximum repayment term generally should not exceed 30 years. Planning for a laddered or serial maturity schedule for outstanding bonds will provide maximum flexibility in managing institutional resources by:
   a. raising or lowering total interest cost of debt
   b. raising or lowering annual payments
   c. matching useful life of the project with anticipated cash flows
   For purposes of inter-generational equity, serial maturities properly match the debt service requirements of the project with the cash flows from the beneficiaries of the financed facility. raising or lowering interest cost of debt
3. Redemption
   Call provisions in the bond indenture give flexibility to redeem bonds prior to maturity if the University is in a position to do so financially, and if current market conditions are favorable.
4. Interest Rates
   Interest rates should be reflective of the institution's credit worthiness, the type of debt instruments being used, and general market conditions. The institution seeks to borrow at the lowest practical cost, while offering a security that will be attractive to potential investors. The University will consider the following factors in evaluating interest rates for specific borrowings:
   a. fixed rates are usually higher than variable rates
   b. variable rates potentially shorten maturity for the investor
   c. a lower rate for the same maturity means a transfer of risk from investor to issuer
   d. trade-offs exist between certainty and lower cost
   e. a portion of the University's debt in a variable-rate mode allows it to better match assets and liabilities

D. Tax-exempt vs. taxable debt

The University recognizes the inherent benefit of tax-exempt interest rates and manages its debt portfolio to maximize the utilization of tax-exempt debt and minimize the use of taxable debt. Taxable debt may be utilized to fund projects or to refinance outstanding debt that are ineligible for tax-exempt financing, or where taxable debt provides additional project or financial flexibility not afforded under the restrictions imposed on tax-exempt debt. In particular, a combination of taxable and tax-exempt bonds will be issued for projects with a private use component that exceeds IRS thresholds for tax-exempt debt. The private use of tax-exempt financed projects will be monitored as part of the annual continuing disclosure reporting requirements. As a tax-exempt bond project is being considered, the University will collect information related to such project and the uses of the facilities that may be considered benefiting a private party. Any time there is a potential change in use of a tax-exempt bond funded facility, the University will discuss the change with bond counsel, in advance, to ensure that there is no impact on maintenance of the tax-exempt status of the bonds.

E. Fixed rate vs. variable rate debt

The University recognizes that a degree of exposure to variable interest rates within the debt portfolio is desirable in order to:

1. provide repayment/restructuring flexibility
2. benefit from historically lower average interest costs
3. provide a "match" or natural hedge to the University's short-term investment balances

Fixed-rate debt provides more long-term interest rate stability than variable-rate debt. However, variable rate debt can be a desirable component of the debt portfolio for the reasons stated above.. Variable rate debt includes floating rate issues and commercial paper, as well as any “synthetic” variable rate debt created by use of fixed-to-floating interest rate “swaps”. The use of variable rate debt does expose the debt portfolio to interest rate risk. Therefore, the University will constantly evaluate the portfolio’s overall interest rate exposure. The portfolio allocation to variable rate debt may be managed or adjusted through:

a. the issuance of debt (new issues and refundings), and
b. the use of interest rate swaps and other derivative products

The University’s portfolio of variable rate debt may require liquidity support in the event that obligations are put back to the University by investors, requiring an immediate purchase. The University can purchase liquidity support externally from a bank in the form of a standby bond purchase agreement (SBPA) or line of credit; or can use its own capital in the form of self-liquidity. The University will manage its liquidity needs vis-à-vis variable-rate debt considering the entire asset and debt portfolio, rather than on an issue-specific basis.

F. Derivative products

Derivative products may limit interest rate exposure and reduce debt service costs and may enable more opportunistic and flexible management of the debt portfolio.

1. Allowable instruments

   Interest rate swaps may be employed to manage or hedge interest rate exposure or to lower expected debt costs. In the case of a variable-to-fixed rate swap, in which the University effectively pays a synthetically fixed rate of interest, the University will achieve a lower cost of capital than traditional fixed rate bonds. Floating, fixed rate, auction or reset securities, and other forms of debt bearing synthetically determined interest rates may also be considered.

2. Risk assessment/mitigation

   The University recognizes the risks associated with derivative products and will evaluate potential derivative instruments through consideration of:

   a. variable-rate allocations within the University’s debt portfolio
   b. market and interest rate conditions
   c. impacts on future financing flexibility and financial reporting, and
   d. counterparty exposure and other risks

   The University will analyze and quantify the costs/benefits of any derivative instrument relative to achieving its long-term capital structure objectives and will consider risk mitigation features

IV. Limitations on debt issuance

A. Institutional equity participation

Debt will be considered a financing tool to fill in the resource gaps that cannot be met by other means. Capital projects will generally not be funded by issuing debt if existing resources are available and adequate to fully fund the cost of construction or renovation being planned, or the cost of a capital asset being purchased.

B. Authority to issue debt

1. Board of Trustees

Approval of the Board of Trustees is required for the issuance of all bonds and certificates of participation. The Trustees must also approve new lease and other debt obligations exceeding $10 million (see University of Utah Policy 1-5.1).

2. Board of Regents

   This Debt Policy attempts to provide additional details regarding the issuance and management of debt by the University – within the context granted to it by its legal bonding authority – the State Board of Regents of the State of Utah (the Regents). The relevant Regents' policy governing these matters is contained in Policy R590 "Issuance of Revenue Bonds for Facilities Construction or Equipment" and Policy R710, "Capital Facilities". The University will comply with existing policy issued by the Board of Regents and any future policies dealing with the issuance and management of debt.

3. State Legislature

   The State of Utah, through its legislature, has enacted laws relating to the issuance of Revenue Bonds, with which the University will comply (see Utah Code Title 53B, Chapter 21). Special authority to issue debt below a certain dollar threshold (currently $10 million), without legislative approval, is given to the University through the provisions of Utah Code Title 11, Chapter 17 (Utah Industrial Facilities and Development Act).

C. Debt capacity

The University has legally-binding indenture-driven obligations that serve as limitations for determining debt capacity. The University also has identified core financial measures to assist in an ongoing assessment of its debt capacity. These measures assist management in maintaining the University's credit profile compared to industry benchmarks, peer institutions, and strategic planning objectives. They are intended to serve as a guideline and framework for issuing debt and may assist the University in establishing certain "floors" – especially where long or short-term strategic objectives are paramount.

V. Debt management

A. Refunding/refinancing opportunities

The University will actively consider current or advanced refunding opportunities of outstanding debt in light of the following factors:

1. Savings requirements

   The net present value savings will be positive (generally a minimum of 3%), or

2. Other factors

   The refunding will support a strategic need by providing relief of certain limitations, covenants, payment obligations, or reserve requirements that reduce flexibility.

B. Relevant ratios

Debt Service Coverage is the key relevant ratio, and will be calculated to show the effect of a new bond issue before funding of a project is presented for approval to the Board of Trustees and the Regents. Debt Service Coverage is calculated by dividing the net revenues of a particular bond system by total debt service (including the debt service on the proposed bond issue). This ratio indicates the direction and degree to which the University has balanced annual operating expenses with revenues, and demonstrates that a net revenue stream exists to meet the current and projected debt burden. The calculation of net revenues should be adjusted for (by adding back) interest expense and depreciation.

The University may consider tracking other ratios from time to time, as necessary or desired, in light of its strategic initiatives and expected capital requirements. Such ratios might include:

1. Viability ratio – expendable net assets / total long-term debt
   This ratio indicates one determinant of financial health by measuring the availability of liquid net assets to cover debt should the University be required to repay all of its outstanding obligations immediately. This ratio is indicative of balance sheet debt capacity. Although the balance sheet does not actively influence debt affordability and budgeting decisions, leverage represents an importance consideration in credit quality. This ratio should always be above the 1:1 level.
2. Debt burden (capacity) ratio – annual debt service (principal + interest) / total operating expenses (adjusted for depreciation and principal payments)
   This ratio measures the University's ability to repay interest expense associated with all outstanding debt and the impact on the overall operating budget. This ratio also measures the relative cost of debt to overall University expenditures (total expenses – depreciation + principal payments). By maintaining an appropriate proportion of debt service to total expenses, other critical and strategic needs can be met as part of the expense base. A level trend will provide an indication that there is sufficient coverage for debt service while not impeding financial resources to support institutional requirements. A rising trend will signify a demand on financial resources to cover the debt service, which may result in budgetary reductions. It is intended to maintain the University's long-term operating flexibility to fund new initiatives.

C. Credit enhancements

1. Debt service reserve funds/reserve fund instruments (surety bonds)
   Setting aside funds in reserve to pay debt service or purchasing a surety bond are both tools to enhance the issuers credit with the bond rating agencies and the investors. Both options will provide assurance to the bond holders and others that, in the event of a financial emergency on the part of the issuer, there will be a dedicated source of funds that can be made available to assure that upcoming principal and interest payments can be made.
2. Bond insurance
   An insurance policy that guarantees timely payment of interest and principal if the issuer is unable to do so will be purchased when it is economically advisable to do so.

VI. Credit worthiness

A. State of Utah moral obligation feature

The University's credit worthiness is enhanced by the existence of a "moral obligation" on the part of the State of Utah. In the event of a financial deficiency on the part of the University, the Board of Regents certifies to the Governor the deficiency; and the Governor may ask the legislature to consider an appropriation to replenish reserves or make the necessary debt service payments should the University be unable to do so.

B. Rating agencies

The ratios described herein are consistent with the measures used by the rating agencies, who monitor a number of ratios and other statistics in developing their opinions. Management will review annually all key rating agencies' ratios to monitor compliance with rating guidelines.

VII. Other considerations

A. Arbitrage

Treasury regulations re: arbitrage rebate require monitoring the interest rate earned on a bond, construction, or debt service reserve fund for each bond series compared to the interest rate paid (the so-called "arbitrage yield"). Therefore, bond proceeds from each bond series will be segregated into separate funds. Any excess interest earnings above that allowed under current law will be paid to the IRS as arbitrage rebate. The University will comply with arbitrage requirements on any invested bond funds through establishment of appropriate accounting and reporting procedures. These include tracking investment earnings on unspent bond proceeds, calculating rebate payments, and remitting any arbitrage rebate in a timely manner. Bond proceeds will be invested appropriately to achieve the highest return available under arbitrage limitations.

B. Continuing disclosures

The University will meet its ongoing disclosure requirements in accordance with SEC rule 15c2-12, by submitting financial reports, statistical data, and any other material events, as required, under outstanding bond indentures. Each bond system may have a different deadline for submitting the annual disclosure report to the proper authorities, but in general, the University strives to have these reports completed and submitted within 180 days of the end of the fiscal year.

C. Internal controls

The University will adhere to the following internal controls relating to debt.

1. All debt transactions must be initiated by authorized individuals and approved by the Board of Trustees, and (when necessary) the Board of Regents and the State Legislature.
2. All documents relating to notes, bonds, and other debt instruments are subject to effective custodial controls and physical safeguards.
3. Adequate detailed accounting records are maintained and appropriate reports issued.
4. All transactions are properly accumulated, classified, and summarized in the accounts.

D. Capitalized interest

Interest paid on bonded debt during the construction period may be capitalized as part of the overall asset cost recorded on the University's books at the conclusion of the construction period. The University will follow applicable accounting standards, laws and regulations governing the capitalization of interest.

E. Operating leases

Operating leases are treated as current operating expenses. The University is required to report annually on its operating leases to both the Board of Regents and the Board of Trustees (see Regents' policy R710, "Capital Facilities".