FCR 6

Office of the President
May 3, 2011

Members, Board of Trustees:

REVISION OF UNIVERSITY OF KENTUCKY DEBT POLICY

Recommendation: that the Board of Trustees approve the attached revisions to the University of Kentucky's Debt Policy.

Background: The Debt Policy provides a framework to evaluate the appropriate use of debt. The recommended revisions include adjusting the calculation for determining the institution's internal loan capacity and establishing a process for providing cash advances to self-supporting units under extenuating circumstances.

Currently, internal loans are limited to $100 million or 15 percent of the operating investment pool as of the end of the prior fiscal year, whichever is less. The revisions include using a trailing twelve-month average of the operating investment pool to smooth variances in the maximum internal loan amount. The revisions also provide for cash advances of limited duration (maximum 90 days) to self-supporting units under extenuating circumstances. The Debt Management Committee supports the recommendation. The proposed additions are in italics; proposed deletions are lined through.

Action taken: ☑ Approved ☐ Disapproved ☐ Other ______________

Revised May 3, 2011

University of Kentucky

Debt Policy

Purpose

To fulfill its mission, the University of Kentucky must make ongoing strategic capital investments in academic, student life, healthcare, and other plant facilities using an appropriate mix of funding sources including state bonds and appropriations, University bonds, capital leases, internal reserves, operating funds investment pool, and private gifts.

The purpose of the Debt Policy is to ensure the appropriate mix of funding sources is utilized and to provide guidance on the strategic use of debt (external and internal). Debt is a valuable source of capital project financing but should be limited to projects that relate to the mission and strategic objectives of the University. The amount of debt incurred has an impact on the financial health of the University and its credit rating.

This Policy provides a discipline and framework to be used by senior administration to evaluate the appropriate use of debt in capital financing plans.

Objectives of the Debt Policy

The objectives stated below provide the framework for decisions regarding the use and management of traditional and non-traditional external debt and internal borrowing from the University's operating funds investment pool. The Debt Policy and objectives are subject to re-evaluation and change over time.

The Debt Policy:

1. Outlines a process for identifying and prioritizing capital projects considered eligible for debt financing and assuring that debt-financed projects have a clear and feasible plan of repayment. Projects that relate to the core mission and have associated revenues will generally be given higher priority for debt financing.

2. Defines the quantitative tests that will be used to evaluate the University's overall financial health, liquidity, and present and future debt capacity.

3. Defines project-specific quantitative tests, as appropriate, which will be used to determine the financial feasibility of an individual project.

4. Manages the University's external and internal debt to maintain an acceptable credit rating and sufficient liquidity. The University, consistent with its capital objectives, will limit its external debt to a level that will maintain an acceptable credit rating with bond

rating agencies. Maintaining an acceptable credit rating will permit the University to continue to issue debt and finance capital investments at favorable interest rates, although the attainment or maintenance of a specific rating is not an objective of this policy.

Prudent management of cash and cash equivalents is required to preserve the University's financial viability. Internal loans will be managed so they do not detract from the University's investment performance objectives for its cash portfolio and cannot compromise the operational liquidity of the University

5. Establishes guidelines to limit the risk of the total external debt portfolio. The University will manage debt on a portfolio basis, rather than on a transactional or project specific basis, and will use an appropriate mix of fixed and variable rate debt (as permitted by State Law) to achieve the lowest cost of capital while limiting exposure to market interest rate shifts.

6. Establishes guidelines to manage variable rate interest exposure for external debt.

7. Establishes guidelines for internal loans including (a) maximum outstanding internal loan balances; (b) percentage of liquidity that may be utilized; and (c) duration.

8. Assigns responsibilities for the implementation and management of the University's Debt Policy.

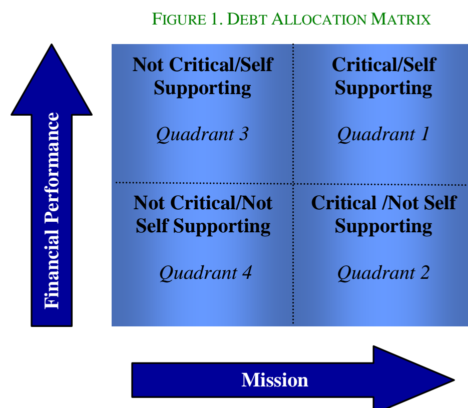
Process for Identifying and Prioritizing Capital Projects Requiring Debt

The University has substantial but limited external debt capacity. Additionally, the University must compete with all other state agencies for capital projects bonding authority as the Commonwealth of Kentucky has imposed limits on the aggregate amount of outstanding debt attributable to the State. Therefore it is essential that the University appropriately prioritize capital projects requiring debt.

The President must determine the amount of debt resources available and submit recommendations on the use of such resources to the Board of Trustees.

The debt allocation matrix below depicts an approach to prioritizing capital projects requiring debt.

FIGURE 1. DEBT ALLOCATION MATRIX



Explanation of debt allocation matrix

Quadrant 1:

Project **is critical** to the core missions of research, service or instruction **and** has its own funding source (i.e., non-general fund supported).

Quadrant 2

Project **is critical** to the core missions of research, service or instruction **but does not** have its own funding source (i.e., will require-general fund support).

Quadrant 3

Project is **not critical** to the core missions of research, service or instruction **but** has its own funding source (i.e., non-general fund supported).

Quadrant 4

Project is **not critical** to the core missions of research, service or instruction **and does not have** its own funding source (i.e., will require general fund support).

Note that approval of projects in Quadrant 3 and 4 will reduce the ability to issue debt for the mission critical projects identified in Quadrants 1 and 2.

Guidelines for Prioritizing Capital Projects Requiring Debt

The following guidelines will be used to prioritize capital projects and make decisions about financing options and use of debt:

1. Only projects related to the mission of the University, directly or indirectly, will be eligible for debt financing.

2. In assessing the possible use of debt, all financing and revenue sources will be considered such as state bonds, University bonds, philanthropy, project-generating revenues, research facilities and administration cost reimbursement, expendable reserves, capital leases, and internal loans from the University's operating funds investment pool. Internal and external debt is to be used conservatively and strategically.

3. The University will consider other funding opportunities (e.g., joint ventures, real estate development, etc.) when appropriate and advantageous to the University. Opportunities and financing sources will be evaluated within the context of the Debt Policy.

4. Federal research projects will receive priority consideration for debt financing due to partial reimbursement of operating expenses (including the interest component of applicable debt service) of research facilities.

Every project considered for financing must have a defined, supportable plan of costs (construction and incremental operating) approved by the Provost or appropriate executive vice president. A project that has a related revenue stream or can create budgetary savings will receive priority consideration. However, projects may not receive a higher priority simply because they are self supporting.

Internal Loans and Cash Advances

Internal Loans

Internal loans of available funds in the University's operating funds investment pool can provide an alternate source of funding when external debt is not available or when there is a gap between the receipt of funds such as a gift or grant and the date of acquisition or construction of a project. The life of an internal loan is generally more than one year.

The following guidelines apply:

1. Internal loans cannot compromise the operational liquidity of the University. The University must maintain at least 60 days of operating cash at all times.
2. All requests for internal loans shall be submitted to the Debt Management Committee by the Provost or appropriate executive vice president for review and recommendation to the President. Any internal loan greater than $600,000 must be approved by the Board of Trustees.
3. The aggregate of outstanding internal loans will be continuously monitored by the Vice President for Financial Operations and Treasurer and should not exceed $100 million or 15 percent of the University's operating funds investment pool based on the average of the trailing twelve months balances, whichever is less. A report on the outstanding internal loans of cash and cash equivalents will be provided annually to the Investment Committee of the Board of Trustees.

Deleted: as of the end of the prior fiscal year

4. Endowment funds may not be loaned or considered in determining the number of days of operating cash available.
5. Prior to the transfer of internal loan funds, a memorandum of agreement shall be executed by the Provost and/or appropriate executive vice president(s). The agreement shall identify the debt service fund source, formal repayment schedule, interest rate, and specified term.
6. The maximum loan term is 75 percent of the estimated useful life of the asset or 20 years, whichever is less.
7. Interest shall be charged based on a two-year treasury note plus 100 basis points (1.0%). The annual interest rate will be determined March 1 and be effective for the following fiscal year.

Cash Advances

Under extenuating circumstances, the University may advance cash for a limited duration (not to exceed 90 days) to self-supporting units. Such advances for working capital or to cash-flow capital projects must not compromise the University's operational liquidity and must be approved by the Executive Vice President for Finance and Administration (EVPFA). Prior to a cash advance, a memorandum of agreement shall be executed by the Provost and/or appropriate executive vice president(s). The agreement shall identify the source of repayment, repayment schedule, interest rate, and specified term. Cash advances will not be considered in determining the maximum internal loan capacity.

Any cash advance which exceeds 90 days will be re-classified as an internal loan and subject to the aforementioned guidelines.

The President, upon recommendation by the Debt Management Committee, may approve exceptions to the Internal Loans and Cash Advances guidelines.

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Financial Ratios/Institutional Quantitative Tests

The University will establish guidelines for overall debt management using a select number of financial ratios calculated and reported annually and when new debt is issued; and revised periodically to reflect any changes in accounting standards. Financial ratios will serve as indicators of the University's financial health and capacity to incur debt. Calculation of these ratios will be based on the audited consolidated financial statement on a University-wide basis.

Ratios fall into two specific categories: (a) financial ratios that provide information about the overall financial health of the University and (b) ratings indicator ratios that are specific to the ability to issue debt and are key determinants used by the rating agencies in rating the University's bonds.

1. ***RATIOS THAT PROVIDE INFORMATION ABOUT THE UNIVERSITY'S OVERALL FINANCIAL HEALTH.***

The following four strategic financial ratios, when considered together and over time, will help to provide a clear, high level, assessment of the overall financial health of the University.

a. **Primary Reserve Ratio**. Measures financial strength by comparing expendable net assets to total expenses. This ratio provides a snapshot of financial strength and flexibility by indicating how long the University could function using its expendable resources without relying on additional net assets generated by operations. A negative ratio or decreasing trend over time indicates a weakening financial condition.

b. **Return on Net Assets Ratio**. Determines whether the University is financially better, or worse, than in previous years by measuring total economic return.

c. **Net Operating Revenue Ratio**. Indicates whether total operating activities resulted in a surplus or deficit and measures the ability of the University to operate in the short term.

d. **Viability Ratio**. Measures the availability of expendable net assets to cover debt. As this ratio falls below 1:1, the University's ability to respond to adverse conditions, to attract capital from external sources, and its flexibility to fund new objectives is diminished. This ratio is regarded as an important indicator of the ability to assume new debt.

RATINGS INDICATOR RATIOS

In addition to the four strategic financial ratios, there are many other ratios used by bond rating agencies in rating debt. These ratios, referred to as ratings indicator ratios, are specific to the ability to issue debt and are key determinants in the debt ratings assigned by the rating agencies. The following are considered among the important ratings indicator ratios:

a. **Unrestricted Resources (Net Assets) to Operating Expenses** (times coverage) *and* **Expendable Resources (Net Assets) to Operating Expenses** (times coverage). These two balance sheet ratios provide indicators of near-to-medium term financial health by measuring the availability of unrestricted and expendable funds to cover debt should unexpected interruptions in cash flow occur. They provide an indicator of short term liquidity and/or financial flexibility in periods of volatility.

b. **Unrestricted Resource (Net Assets) to Debt** (times coverage) *and* **Expendable Resources (Net Assets) to Debt** (times coverage). These two capital ratios measure the University's liquid assets to its debt.

c. **Peak Debt Service to Operating Expenses** (percentage). Measures the University's longer term debt and related operating flexibility.

d. **Operating Margin and Average Operating Margin** (percentage). Measures the University's excess margin (or deficit) by which revenues cover expenses (including depreciation of capital assets and interest expense) annually, and averaged over a three year period.

e. **Average Peak Debt Service Coverage** (times coverage). Measures the ability to repay debt from current operating funds. This ratio measures, over a three year period, whether sufficient operating cash flow is generated to issue and repay additional debt.

f. **Direct Debt to Cash Flow** (times coverage). Measures the total debt burden compared to its annual cash flow generating ability.

g. **Cash Flow Operating Surplus** (percentage). Measures total operating surplus (operation surplus, depreciation, and interest on capital related debt) as a percent of total revenue.

Project Specific Quantitative Tests

Consideration of the ratios calculated above will determine the ability and/or advisability of issuing additional debt from a University-wide perspective. Determination of the prioritization of individual projects to be allocated a portion of available debt capacity is a separate, internal decision that must be made before a project is initiated.

Many factors will influence this internal decision process. First, how the project will be prioritized with regard to importance to the University's mission as described by the debt allocation matrix (four quadrant model) above. Additionally, every project considered for debt financing must have a management-approved plan of project costs, including incremental operating expenses and revenues. Incremental revenues include revenue increases directly associated with the project (e.g., usage fees) that can only be realized if the project is undertaken. Similarly, incremental expenses include any increase in expected operating costs associated with the project. Revenues and costs savings should be estimated conservatively, especially for high risk projects. The net present value of each project will be calculated by summing the discounted value of the annual net project cash flows over the life of the project.

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Mix of Fixed and Variable Debt

Due to the financing flexibility and lower interest cost typically associated with variable rate debt, it may be desirable, depending on market conditions, to maintain a portion of the University's aggregate debt on a floating (variable) rate basis. However, variable rate debt also introduces volatility to the debt service obligations. Therefore, the University will balance the mix of variable and fixed rate debt according to a maximum of 50% variable, with a target guideline of zero to 30% variable, although the actual percentage for debt outstanding will fluctuate from time-to-time due in part to financing needs and prevailing market interest rates.

Use of Interest Rate Swap Products

The use of interest rate swaps will be employed primarily to manage the University's variable rate exposure. The University will utilize a framework to evaluate potential instruments through evaluation of its variable rate allocation, market and interest rate conditions, and the compensation for undertaking counterparty exposure.

Credit Rating

The University will maintain ongoing communications and interaction with bond rating agencies to educate the agencies about the general credit structure and financial performance of the University in order to attain the highest credit rating possible.

Assignment of Responsibilities

The Executive Vice President for Finance and Administration is directly responsible for all debt management.

Facilities Planning and Facilities Management

The Vice President for Facilities is responsible for estimating and defining capital project costs and in maintaining a list of projects that are being considered. The Vice President for Financial Operations and Treasurer is responsible for developing capital planning documents for the current year, current biennium and the six-year capital plan.

Treasury Management

The Vice President for Financial Operations and Treasurer will maintain a schedule of current and forecasted debt (external and internal) and associated payment of principal, interest, and fees. He or she is responsible for the administration of all aspects of debt financing, including accounting, reporting, and coordination with financial advisors, underwriters, and bond counsel to issue new debt or refinance existing debt.

Management

A debt management committee consisting of the following members and any other individual designated by the Executive Vice President for Finance and Administration will meet on a regular basis to review the University's internal and external debt capacity, liquidity measures, and projects requested to be funded in whole or in part with debt.

- Provost
- Executive Vice President for Finance and Administration
- Vice President for Facilities
- Vice President for Financial Operations and Treasurer
- Vice President for Health Affairs and Chief Financial Officer

The projects to be considered must be submitted by the Provost or an executive vice president. The Executive Vice President for Finance and Administration will present the committee's recommendations to the President.

Board of Trustees

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The Board of Trustees will review and approve the annual capital project plan as well as each individual debt financing transaction exceeding $600,000. Additionally, the Board will review and approve the implementation of this Debt Policy and will be apprised of any significant future changes proposed.

Review of Debt Policy

This Debt Policy should be reviewed at least annually by the Debt Management Committee designated above and changed as needed to reflect current conditions and practices. However, it is noted that consistent application of the University's Debt Policy provides evidence of debt management discipline over the long term. Accordingly, the Policy should be changed only when it no longer reflects the debt philosophy of the University.

Debt Management Practices

Structure and Maturity

The University will issue bonds to finance capital projects under the provisions of trust indentures approved by the Board of Trustees. The following trust indentures have been approved by the Board of Trustees:

- General Receipts Obligation Revenue Bonds
- Consolidated Educational Buildings Revenue Bonds
- Consolidated Housing and Dining System Revenue Bonds

Debt in the form of capitalized lease obligations will be approved by the Board of Trustees and issued on behalf of the University by the Commonwealth of Kentucky's Asset Liability Commission, the State Property and Buildings Commission, and other financing entities.

The University will employ maturity structures that correspond with the life of the facilities financed, generally not to exceed 20 years. As market dynamics change, maturity structures should be reevaluated. Call features should be structured to provide the highest degree of flexibility relative to cost.

Methods of Sale

The University will use the method of sale which will achieve the lowest cost of capital considering the complexity of the transaction. Generally, this can be achieved utilizing a competitive sales method for the placement of bond offerings. However, for transactions using new or non-traditional pledges of University revenues, or those involving greater complexity, a negotiated method of sale will be considered, and legislative approval requested, on an

individual transaction basis. The negotiated sales method allows the utilization of a greater scope of services from the underwriting community.

REFUNDING TARGETS

The University will continuously monitor its outstanding tax-exempt debt portfolio for refunding and/or restructuring opportunities.

For a stand-alone refunding, the University will enter into an advance refunding transaction that, in general, produces at least 3-5% present value savings (based on refunded bonds), with this threshold higher for those transactions with a long escrow period. Advance refunding transactions must weigh the current opportunity against possible future refunding opportunities. For current refundings, the University will consider transactions that, in general, produce a least a 1.5 – 3% present value savings (based on refunded bonds). In addition to the net present value percentage savings, the annual dollar savings provided by any refunding will be reviewed, as for large refunding transactions, significant savings may accrue even though the percentage of net present value savings falls below the thresholds defined above.

A refunding also will be considered if it relieves the University of certain limitations, covenants, payment obligations, or reserve requirements that reduce flexibility. The University also will consider refinancing certain obligations within a new money offering, even if savings levels are minimal, in order to consolidate debt into a general revenue pledge and/or reduce the administrative burden and cost of managing many small outstanding obligations.

DISCLOSURE

The University will continue to meet its ongoing disclosure requirements in accordance to Securites and Exchange Commission Rules 15c2-12. The University will submit financial reports, statistical data, and any other material events as required under outstanding bond indentures.

ARBITRAGE

The University will comply with federal arbitrage requirements on invested tax-exempt bond proceeds, causing arbitrage rebate calculations to be performed annually and rebate payments to be remitted to the Internal Revenue Service periodically, as required.

BOND PROCEEDS INVESTMENT

The University, in concert with the Commonwealth of Kentucky's Office of Financial Management, will invest bond-funded construction funds, capitalized interest funds, and costs of issuance funds appropriately to achieve the highest return available under arbitrage limitations. When sizing bond transactions, the University will consider funding on either a net or gross basis.

OFFICE OF FINANCIAL MANAGEMENT

The Commonwealth of Kentucky's Office of Financial Management, in accordance with Kentucky Revised Statute 42.400, shall review and approve, prior to the issuance, all proposed bond issues, bond anticipation notes, or interim external debt financings.

Selection of Financial Advisors, Underwriters and Bond Counsel

The University will, in accordance with Kentucky Revised Statute 45A.840, utilize a Request For Proposal process to select financial advisors, underwriters and bond counsel. Multiple firms may be selected to provide financial advisory, underwriting, and bond counsel services for a specific contract period of time. The firms utilized on an individual transaction will be selected based upon expertise related to the specific transaction. Additionally, the University may utilize the financial advisors, underwriters and bond counsel selected by the Commonwealth of Kentucky's Office of Financial Management through their own similar competitive process.

Appendix A

Formulas and Benchmarks for Key Ratios

RATIOS THAT PROVIDE INFORMATION ABOUT THE UNIVERSITY'S OVERALL FINANCIAL HEALTH

1. PRIMARY RESERVE RATIO

$$\frac{\text{EXPENDABLE NET ASSETS}^{1}}{\text{TOTAL EXPENSES}^{2}}$$

2. RETURN ON NET ASSETS RATIO

$$\frac{\text{CHANGE IN TOTAL NET ASSETS}}{\text{TOTAL NET ASSETS, BEGINNING OF THE YEAR}}$$

3. NET OPERATING REVENUES

$$\frac{\text{OPERATING INCOME (LOSS) + NET NON-OPERATING INCOME (EXPENSES)}}{\text{TOTAL OPERATING REVENUES + TOTAL NON-OPERATING REVENUES (EXCLUDING CAPITAL APPROPRIATIONS \& GIFTS, AND ADDITIONS TO PERMANENT ENDOWMENTS)}}$$

4. VIABILITY RATIO

$$\frac{\text{EXPENDABLE NET ASSETS}}{\text{LONG TERM DEBT (BONDS AND CAPITAL LEASES)}}$$

[1] Expendable net assets = unrestricted net assets plus expendable restricted net assets less expendable assets to be invested in plant.
[2] Total expenses = operating expenses plus non-operating expenses

RATINGS INDICATOR RATIOS

1A. UNRESTRICTED RESOURCES (NET ASSETS) TO OPERATING EXPENSES (TIMES COVERAGE)

$$\frac{\text{Unrestricted Net Assets}}{\text{Total Operating Expenses}^{3}}$$

1B. EXPENDABLE RESOURCES (NET ASSETS) TO OPERATING EXPENSES (TIMES COVERAGE)

$$\frac{\text{Expendable Resources}^{4}}{\text{Operating Expenses}}$$

2A. UNRESTRICTED RESOURCES (NET ASSETS) TO DEBT (TIMES COVERAGE)

$$\frac{\text{Unrestricted Net Assets}}{\text{Debt}^{5}}$$

2B. EXPENDABLE RESOURCES (NET ASSETS) TO DEBT (TIMES COVERAGE)

$$\frac{\text{Expendable Resources}}{\text{Debt}}$$

3. PEAK DEBT SERVICE TO OPERATING EXPENSES (%)

$$\frac{\text{Maximum Annual Principal and Interest on all Debt}}{\text{Total Operating Expenses}}$$

[3] Total Operating expenses= operating expenses per SRECNA, less student financial aid expense plus interest on capital asset related debt.
[4] Unrestricted net assets plus expendable restricted net assets
[5] Par amount of debt = Consolidated Educational Building Revenue Bonds, Housing & Dining System Revenue Bonds, Hospital Revenue Bonds, Library Bonds, capital leases and notes payable.

4a. Operating margin (Percentage)

$$\frac{\text{Annual Operating Margin}^{6}}{\text{Total Operating Revenues}^{7}}$$

4b. 3-Year Average Operating margin (Percentage)

$$\text{Three year average of } \frac{\text{Annual Operating Margin}}{\text{Total Operating Revenues}^{8}}$$

5. 3 –year Average Peak Debt Service Coverage (Times Coverage)

$$\frac{\text{3 Year Average (Annual Operating Margin + Depreciation and Interest Expense)/}}{\text{current year Peak debt service}^{9}}$$

6. Direct Debt to Cash Flow (Times Coverage)

$$\frac{\text{Debt}}{\text{Operating Margin + Depreciation and Interest Expense}}$$

7. Current Year Operating Surplus (Percent)

$$\frac{\text{Operating surplus + Depreciation + Interest on Capital Related Debt}}{\text{Total Operating Revenue}}$$

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[6] Annual operating margin = net (loss) from operations per SRECNA, + state appropriations, + gifts/grants (non-capital and non-permanent endowment) + 4.5% of the prior year-end cash and investments, minus interest on capital related debt.
[7] Total operating revenues = operating revenues per SRECNA +state appropriations, + gifts/grants (non-capital and non-permanent endowment) + 4.5% of the prior year-end cash and investments, minus student financial aid expense.
[8] Total operating revenues = operating revenues per SRECNA +state appropriations, + gifts/grants (non-capital and non-permanent endowment) + 4.5% of the prior year-end cash and investments, minus student financial aid expense.
[9] Maximum debt service on all debt as of the end of the most recent fiscal year.