FCR 23

Office of the President
September 20, 2005

Members, Board of Trustees:

ADOPTION OF UNIVERSITY OF KENTUCKY DEBT POLICY

Recommendation: that the Board of Trustees adopt the proposed Debt Policy for the University of Kentucky.

Background: To fulfill its mission, the University of Kentucky will need to make ongoing strategic capital investments for academic, student life, and other plant facilities, using an appropriate mix of funding sources, including state bonds and appropriations, university bonds, internal reserves, and private giving.

The purpose of this debt policy is to ensure that the appropriate mix of funding sources is utilized and to provide guidance on the strategic use of debt as a funding source. Debt is a valuable source of capital project financing, and its use should be limited to projects that relate to the mission and strategic objectives of the university. The amount of debt incurred impacts the financial health of the university and its credit rating.

This policy provides a discipline and framework that will be used by management to evaluate the appropriate use of debt in capital-financing plans. Maintaining this debt policy is a long-term process.

Action taken: ☑ Approved ☐ Disapproved ☐ Other ____________________

University of Kentucky

Debt Policy

Purpose

To fulfill its mission, the University of Kentucky will need to make ongoing strategic capital investments for additional academic, student life, and other plant facilities using an appropriate mix of funding sources including State bonds and appropriations, University bonds, internal reserves, and private giving.

The purpose of this debt policy is to ensure the appropriate mix of funding sources is utilized and to provide guidance on the strategic use of debt as a funding source. Debt is a valuable source of capital project financing and its use should be limited to projects that relate to the mission and strategic objectives of the University. The amount of debt incurred impacts the financial health of the University and its credit rating.

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Objectives of the Debt Policy

The objectives stated below provide the framework by which decisions will be made regarding the use and management of debt. The debt policy and objectives are subject to re-evaluation and change over time.

This Debt Policy is set forth to:

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

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

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

4. Manage the University's debt to maintain an acceptable credit rating. The University, consistent with the capital objectives, will limit its overall 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.

5. Establish guidelines to limit the risk of the total 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. Establish guidelines to manage variable rate interest exposure.

7. Assign responsibilities for the implementation and management of the University's Debt Policy.

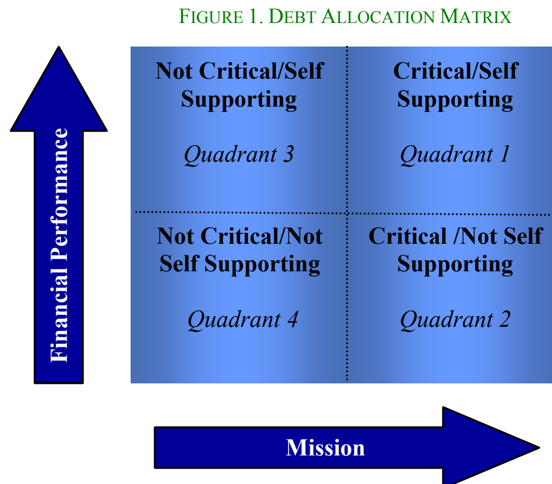
Process for Identifying and Prioritizing Capital Projects Requiring Debt

The University has substantial but limited debt capacity at a desired credit rating level. Additionally, the Commonwealth of Kentucky has imposed State-wide limits on debt issuance and the University must compete with all other state agencies for capital projects bonding authority. Therefore it is essential that the University appropriately prioritize capital projects requiring debt.

Management will allocate the use of debt financing within the University to include prioritization of debt resources among all uses, including academic and student life projects, plant and equipment financing, and projects with University-wide impact.

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 critica**l 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

Management will use the following guidelines when prioritizing capital projects and making 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. State funding and philanthropy are expected to remain major sources of financing for the University's capital investments. In assessing the possible use of debt, all other financing and revenue sources will be considered. State appropriations and bonds, philanthropy, project-generating revenues, research facilities and administration cost reimbursement, expendable reserves, and other sources are expected to finance a portion of the cost of a project. 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.

5. Every project considered for financing must have a defined, supportable plan of costs (construction and incremental operating) approved by management. 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.

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.

2. 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 occur in cash flow. 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 3 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.

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 and foremost will be how the project is prioritized with regard to mission criticality 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.

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, striving 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 capital debt management.

Facilities Planning and Facilities Management

The Vice President for Facilities will take the lead role in estimating and defining project costs and in maintaining a list of projects that are being considered. The Vice President for Planning and Budget will take the lead role in developing capital planning documents for the current year, current biennium and the six-year capital plan.

Treasury Management

The Treasurer will maintain a schedule of current and forecasted debt and associated payment of principal, interest and fees. The Treasurer is responsible for the administration of all aspects of debt financing, including accounting, and coordination with financial advisors, underwriters and bond counsel to issue new debt or refinance existing debt.

Management

The Executive Vice President for Finance and Administration, the Vice President for Facilities, the Vice President for Planning and Budget and the Treasurer will meet on a regular basis to review the projects being considered and the various financing options available. They will discuss options and recommend a priority order. The Executive Vice President for Finance and Administration will present the recommendations of this group to the President.

Board of Trustees

The Board of Trustees will review and approve the annual capital project plan as well as each individual debt financing transaction. 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 and changed as needed to reflect changing 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 not be changed unless 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 will also be considered if it relieves the University of certain limitations, covenants, payment obligations or reserve requirements that reduce flexibility. The University will also 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 SEC rule 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 IRS 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 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

EXPENDABLE NET ASSETS[1]
TOTAL EXPENSES[2]

2. RETURN ON NET ASSETS RATIO

CHANGE IN TOTAL NET ASSETS
TOTAL NET ASSETS, BEGINNING OF THE YEAR

3. NET OPERATING REVENUES

OPERATING INCOME (LOSS) + NET NON-OPERATING INCOME (EXPENSES)
TOTAL OPERATING REVENUES + TOTAL NON-OPERATING REVENUES (EXCLUDING CAPITAL APPROPRIATIONS & GIFTS, AND ADDITIONS TO PERMANENT ENDOWMENTS)

4. VIABILITY RATIO

EXPENDABLE NET ASSETS
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)

$$\frac{\text{3 YEAR AVERAGE (ANNUAL OPERATING MARGIN + DEPRECIATION AND INTEREST EXPENSE)/}}{\text{CURRENT YEAR PEAK DEBT SERVICE}^{9}}$$

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6. DIRECT DEBT TO CASH FLOW (TIMES COVERAGE)

$$\frac{\text{DEBT}}{\text{OPERATING MARGIN + DEPRECIATION AND INTEREST EXPENSE}}$$

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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.