

# **ADMINISTRATIVE PRACTICE LETTER**

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## **SUBJECT: DEBT POLICY**

### **GENERAL**

This Administrative Practice Letter - Debt Policy of the University System addresses the guidelines for the University System to issue debt, and the factors to consider when evaluating the capital structure of the University System. These factors include the University System's debt capacity, bond credit ratings, the level of fixed and variable interest rate exposure, off-balance sheet financings, the use of interest rate swaps or other derivative products, methods of sale, and procedures for reporting to the Board. The Debt Policy will help the University System to manage its cost of capital, to mitigate risks associated with its debt, and to monitor its debt.

The Board of Trustees sets policy regarding debt. The Board delegates authority to implement the policy to the Treasurer. The State of Maine legislature establishes the maximum borrowing capacity for the University System.

### **GOALS OF ISSUING DEBT**

The University System's goal is to strategically manage debt:

1. To provide cost-effective funding for acquiring or replacing long-lived capital assets;
2. To match the cost of funding with the benefits received over the useful life of capital improvements;
3. To leverage other capital funding sources, such as matching state, federal, private and operating funding;
4. To issue internal debt financing for short-term operating or emergency borrowing needs of a duration less than five years (see System Internal Loans APL III-C); and
5. To take advantage of market opportunities to refund outstanding debt for economic savings

### **DEBT CAPACITY AND CAPITAL PLANNING**

Issuance of debt is subject to the University System's overall debt capacity. Periodically, the University System CFO and Treasurer, with consultation from independent financial advisors, will assess and report to the Board of Trustees the University's debt capacity pursuant to target debt ratings. Capacity will be utilized in the capital planning process to determine the aggregate dollar value of projects that can be funded with debt in any given year.

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### **BOND RATINGS**

The University System will attain the highest rating possible and will evaluate the trade-off between capital project funding needs and cost of capital when evaluating financing options. In doing so it will consider the impact any increased debt will have on its credit rating.

The University System intends to maintain a debt rating that ensures adequate funding for University System capital projects and provides ready access to the capital markets at attractive rates relative to market conditions then existing. It is understood that higher credit ratings provide market access at lower interest rates but also limit the amount of debt that may be issued.

The University System will target certain financial ratios as the benchmark for maximum debt level. These include:

- Unrestricted financial resources to debt
- Ratio of debt service to total expenses
- University System debt service coverage ratio

These ratios will be reviewed and monitored annually for the University System as a whole and for each separate University within the University System to determine debt capacity as a whole and for each University.

### **USE OF LONG-TERM FUNDING**

The University System will utilize long term debt, primarily in the form of tax-exempt bonds, to finance long-term assets. The University System will issue debt for capital projects with a dependable long-term source of revenue available for payment. Debt may only be issued for facilities that may be financed pursuant to state statutes governing University System debt borrowings. Debt financings will be coordinated to the extent practical to include multiple project needs in a single borrowing to reduce costs of issuance.

### **USE OF OFF-BALANCE SHEET FINANCING**

The University System will consider off-balance sheet financing when it is desirable to work with a third party, for risk sharing, and for leasing. The University System will consider the impact of such financing on its debt ratios as if the financing were included on its balance sheet.

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### **USE OF DERIVATIVES**

Interest rate swaps and options are appropriate interest rate management tools that can help the University System meet important financial objectives. Properly used, these instruments can increase the University System's financial flexibility, provide opportunities for interest rate savings or enhanced investment yields, and help the University System manage its balance sheet through better matching of assets and liabilities. Swaps should be integrated into the University System's overall debt and investment management guidelines and should not be used for speculation or leverage. The University System's total potential exposure to swap termination payment or counterparty credit risk should not exceed a prudent level as measured against gross revenues, available assets, or other financial resources of the University System. The use of derivatives must be approved by the Board of Trustees.

The University System will only do business with highly rated counterparties (as defined below) or counterparties whose obligations are supported by highly rated parties. The University System will structure swap agreements to protect itself from credit deterioration of counterparties, including the use of credit support annexes (collateral agreement) or other forms of credit enhancement to secure counterparty performance. Such protection shall include any terms and conditions that in the University System's sole discretion are necessary or appropriate or in the University System's best interest.

The University System shall enter into interest rate swap transactions only with qualified swap counterparties. Qualified swap counterparties shall be rated at least "Aa3" or "AA-", or equivalent by any two of the three nationally recognized rating agencies (i.e. Moody's, Standard and Poor's, and Fitch) and not less than A2 or A by the other rating agency, or have, as support for their obligations, a "AAA" subsidiary or other entity (e.g. bond insurer) as rated by at least one nationally recognized rating agency.

### **USE OF VARIABLE RATE DEBT**

The University System will limit unhedged variable-rate debt to a maximum range of 30% of its outstanding indebtedness. The University System will utilize variable-rate debt capacity primarily during periods of high interest rates.

The University System will manage its debt in the context of its overall current and projected financial position, taking into consideration the relationship between its assets and its liabilities, and the investment philosophy of the University System endowment. The University System should consider modifications to the range above as its balance sheet and overall financial condition change.

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It is further recognized that it may be appropriate to utilize variable-rate debt during the construction and start-up period of a project to reduce capitalized interest expense.

### **DEBT STRUCTURE**

1. Revenue Bonds: University System debt is payable solely from University System revenues. Generally, the University System does not grant any security interest to holders of University System bonds or other debt.
2. Maturity of Indebtedness: The maturity of the debt issued will be determined by the purpose of the financing. In general, the maturity of the debt will not exceed the useful life of the assets being financed and debt service will be approximately level each year. Debt service and incremental operating costs associated with the funded project (including provision for replacement) will not exceed expected incremental net revenues/cost savings.
3. Interest Rates: Interest rate structure will be determined by market conditions at issuance. In most cases, the University System will issue fixed rate debt that is expected to be repaid from fixed fees and charges. Variable rate debt will be considered when interest rates are high and it is not advantageous to lock in long-term fixed rates or other times when variable rate debt provides significant benefits. Additionally, variable rate debt may be used as a hedge for the short-term assets subject to variable rates of investment return.

University System debt will be pooled and all projects will be charged an average rate representative of all in cost of capital for fixed interest rate at time of issuance.

4. Refunding Bonds: The University System will issue current and advance refunding debt when material present value savings can be obtained.
5. Redemption Provisions: The University System will seek redemption provisions that are equal to or better than the market.
6. Credit Enhancement: The University System will consider credit enhancement when it materially lowers the cost of debt and does not require material additional debt and operating covenants by the University.

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7. Capitalized Interest: Capitalized interest may be funded during the construction period or the project funding may be borrowed net of anticipated investment earnings during the construction period.
8. The University System CFO and Treasurer will be responsible for monitoring financial and other debt covenants and tax representations and regulations to ensure tax exempt status for the bonds.

### **METHODS OF SALE**

1. Competitive Sales will generally be used to sell bonds. Negotiated bond sales will be used for issues with underlying variable rate bonds and/or issues where the University System requires significant flexibility in timing the market.
2. If negotiated sales are used, underwriters will be selected through a competitive request for proposal (RFP) process. The RFP process will provide for a competitive underwriter's discount while retaining flexibility in timing of debt issuance.
3. Private Placements will be considered for debt issuance where the size is too small or the structure is too complicated or not appropriate for public debt issuance.

### **REPORTING TO BOARD**

The Treasurer will periodically present a report to the Board of Trustees on debt issued, debt outstanding, the University System's estimated debt capacity and credit ratings.

### **APPROVED:**

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**Chief Financial Officer and Treasurer**