

VCU Debt Management Policy

Responsible Offices:
Associate Vice President for Business Services and Treasurer

Treasury and Foundation Services

POLICY STATEMENT AND PURPOSE:

This policy governs the use of debt to finance capital projects and provides a structured framework for approving and managing Virginia Commonwealth University's ("the University" or "VCU") existing debt portfolio as well as future issuances. Recognizing that financial resources are not sufficient to fund all capital projects, the University must allocate debt strategically. The policy will attempt to impose discipline in the debt issuance and management process and aid the Board of Visitors in making high quality debt management decisions.

The policy will provide guidance in the following areas:

- Defining debt capacity and establishing a benchmark for measuring available debt capacity.
- Providing guidance regarding the types and amounts of permissible debt, timing and method of sale that may be used, and structural features that may be incorporated.
- Establishing an interest rate risk management strategy and policy governing the use of derivatives.

The policy will be reviewed periodically and modified as necessary by the Board of Visitors to meet the changing needs of the University.

A. Debt Capacity

Debt capacity is the maximum amount of debt that the University may have outstanding at any given time. The debt capacity ratio will serve as the primary tool for evaluating the portfolio and, ultimately, the University's leverage and risk. The debt capacity ratio measures the University's debt service burden as a percentage of total University expenses (see below). The maximum for this ratio (7%) is intended to maintain the University's long-term operating flexibility to finance existing requirements and any new initiatives.

$$\frac{\text{Maximum Annual Debt Service}}{(\text{Total Operating Expenses} + \text{Interest on Capital Asset Related Debt} + \text{Principal Paid on Capital Asset Related Debt} - \text{Research Operating Expenses})} \leq 7\%$$

The debt capacity ratio will be monitored and reported to the Board of Visitors on an annual basis.

As part of its six-year capital plan, the University will develop a six-year plan for the use of debt financing. The debt financing plan will be updated each biennium and any time a significant

change occurs. In conjunction with its capital plan, the University will monitor its debt capacity ratio, which will be reported to the Board of Visitors on an annual basis and at other times, as requested.

B. Financing Programs

The University finances capital projects through state tax-supported debt secured by appropriations made by the Commonwealth of Virginia and by debt secured directly by the University. When issuing debt secured by the University, VCU has several options including each of the following:

- *9(c) Debt issued by the Commonwealth of Virginia;*
- *9(d) Debt issued by the Virginia College Building Authority; and*
- *9(d) General Revenue Pledge Bonds issued by the University.*

When evaluating a funding source, the University acknowledges the competing benefits, risks, and costs of each. While the most important factor is to seek lowest cost source of financing available, other factors including risk and the composition of the overall portfolio will also be carefully considered.

C. Terms and Structure

Method of Sale

Both negotiated and competitive bond offerings will be considered on a case-by-case basis.

Tax Exempt and Taxable

The University's debt will be managed to use tax-exempt debt to the greatest extent possible while recognizing that taxable debt must be used in the case of projects that are ineligible for tax-exempt financing. Taxable debt may also be used for short periods of interim financing and for financing projects for which taxable financing will provide the maximum operating flexibility.

Amortization

Bond amortization will never be greater than the useful life of the assets or project being financed. Generally, an asset should not be financed for a term greater than 30 years.

The University will consider both level principal and level debt service payment structures and will also consider deferring principal and capitalizing interest. Such decisions will be made on a case-by-case basis.

Call Provisions

Call features should provide maximum flexibility relative to the cost of the features. Generally, call provisions should be as favorable to the University as the market will allow.

Credit Enhancements

Credit enhancements will be used only when necessary for cost effectiveness and/or marketability. Credit enhancements will only be used when the improved bond rating and corresponding reduction in borrowing costs more than offset the costs.

Refinancing Debt

The University will monitor its outstanding debt for refunding and restructuring opportunities. Given the limitations on the number of allowable refinancings, it is important to use refinancing opportunities wisely. Any refunding should produce a minimum net present value savings of three percent, unless the transaction provides relief from certain payments or other limitations, covenants, reserve requirements, or other requirements that limit the University's flexibility.

D. Variable Rate Debt

Variable rate debt can be a valuable tool in debt management, and the University will seek to use variable rate debt strategically to achieve its overall debt portfolio objectives.

Rationale

There are several potential benefits of variable rate securities including, but not limited to, each of the following:

- Lower cost of capital
- Flexibility in principal amortization and/or prepayment
- Diversification of investor base
- Portfolio diversification
- Asset/Liability management

Risks

Variable rate debt will expose the University to risks different than those typically present in traditional fixed rate securities including:

- *Interest Rate Risk* – the risk that interest rates will rise, on a sustained basis, above levels that would have been set if the issue had been fixed.
- *Liquidity Risk* – the risk of having to pay a higher rate to the liquidity provider in the event of a failed remarketing.
- *Rollover Risk* – the risk of the inability to obtain a suitable liquidity facility at an acceptable price to replace a facility upon termination or expiration of the contract period.

Risk Management

To manage these risks, the University will limit the amount of variable rate debt to no more than 30% of its outstanding portfolio. This calculation will be made prior to incurring any additional variable rate exposure. The proportion of variable rate debt represented in the University's total portfolio will be reported to the Board of Visitors annually, or as requested.

To manage interest rate risk, the University may use derivative instruments to hedge its exposure to movements in interest rates.

Bank liquidity facilities should carry a minimum short-term rating of A-1 (Moody's) or P-1 (Standard & Poors). In the event that a liquidity facility is downgraded below a minimum limit, the University may find a replacement.

Approved Variable Rate Instruments

- Auction Rate Securities
- Variable Rate Demand Bonds
- Commercial Paper
- Synthetic floating rate debt

Monitoring and Reporting

On an annual basis, the University will analyze the performance of its variable rate debt and present its findings to the Board of Visitors. If a particular transaction is underperforming and no longer makes economic sense, the University will recommend alternative strategies to the Board.

E. Interest Rate Risk Management

Derivatives can be an effective way to manage interest rate exposures and adjust the mix of fixed and floating rate debt within a portfolio. The University will use derivatives to manage the interest rate risk associated with variable rate debt and to meet other objectives. However, swaps and other hedging instruments will not be entered into for speculative purposes. Under no circumstances will a derivative transaction be utilized that is not understood fully by management or that imposes inappropriate risk on the University.

Rationale

The University may enter into one of these contracts if it is reasonably determined that the transaction is expected to:

- Prudently hedge interest rate risk
- Achieve an overall lower cost of funds
- Synthetically advance refund bond issues
- Increase flexibility

Risks

Before entering into a derivative contract, the University will evaluate the risks including, but not limited to, each of the following:

- *Counterparty Risk* – the risk that a party to the swap will not be able to meet all of its financial obligations under the swap.
- *Termination Risk* – the risk that a swap will be terminated by the counterparty before maturity that could require the University to make a cash termination payment.

- *Basis Risk* – the risk of a mismatch between the University’s floating rate receipt (or payment) on a swap and its floating rate payment (or receipt).
- *Tax Risk* – the risk that the spread between taxable and tax exempt rates will change as a result of changes in income tax laws or other conditions.
- *Rollover Risk* – the risk that results when a swap contract is not coterminous with the related bonds. In the case of a synthetic fixed rate structure, rollover risk is the risk that the University would have to re-hedge its variable rate debt exposure upon swap maturity and incur re-hedging costs.
- *Amortization Risk* – the cost to the issuer of servicing debt or honoring swap payments due to a mismatch between bonds and the notional amount of the swap outstanding.

Risk Management

The University will only enter into a transaction with qualified counterparties who have demonstrated experience in successfully executing similar contracts and who hold at least an AA credit rating by two of the nationally recognized credit rating agencies. In addition, no single counterparty will carry more than 20% of the University’s swap exposure, or \$100 million, whichever is greater.

In negotiating a transaction, the University will include a provision that permits it to optionally terminate a swap agreement at any time over the term of the agreement.

The term of a swap should never extend beyond the final maturity date of the affected debt instrument.

The University will only consider the Bond Market Association Municipal Swap Index (BMA) or the London Interbank Offered Rate (LIBOR) as a floating rate index.

Approved Derivative Instruments

- *Interest Rate Swaps*
- *Interest Rate Caps, Collars or Floors*

Monitoring and Reporting

Annually, the University will report the status of all interest rate swap agreements. The report will provide a detailed description of all interest rate swap transactions entered into by the University and include the following:

- Rates paid and received by the University
- Current market value of the swap agreement
- Termination exposure under each swap agreement
- Credit ratings of each counterparty

F. Credit Ratings

The University shall make every reasonable effort to maintain or improve its underlying credit rating of Aa3/AA- and maintain an active line of communication with each rating agency. The University will report annual financial results to each agency that rates the University's credit.

G. Approval Process

All debt issued, including terms and structure, must be authorized by the Board of Visitors. In addition, the University will seek Treasury Board approval in accordance with § [2.2-2416](#) of the Code of Virginia, as appropriate.

WHO SHOULD READ THIS POLICY:

- Vice Presidents and other Senior Executives
- Vice Provosts, Deans, Directors, and Department Heads

RELATED DOCUMENTS:

- VCU Debt and Risk Management Guidelines
- Department of Treasury Debt Structuring and Issuance Guidelines
- Department of Treasury Variable Rate and Interest Rate Swap Guidelines

CONTACTS:

General and specific questions about this policy can be answered by VCU's Department of Treasury and Foundation Services.

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DEFINITIONS:

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| Amortization Risk | The cost to the issuer of servicing debt or honoring swap payments due to a mismatch between bonds and the notional amount of swap outstanding. |
| Auction Rate Securities (ARS) | Long-term, variable-rate bonds tied to short-term interest rates. Interest rates are reset through a modified Dutch auction process (typically every 7, 28, or 35 days) where securities are sold at the highest price at which sufficient bids are received to sell all the securities offered. ARS trade at par and are callable on any interest payment date. They do not have a put feature and therefore do not require liquidity facility. |
| Basis Risk | Movement in the underlying variable rate indices may not be perfectly in tandem, creating a cost differential that could result in a net cash outflow from the issuer. Also, the mismatch that can occur in a swap with both sides using floating, but different, rates. |
| BMA Index | The Bond Market Association Municipal Swap Index is the principal benchmark for the floating rate payments for tax-exempt issuers. The index is a national rate based on a market basket of high-grade, seven-day, tax-exempt, variable rate bond issues. |
| Counterparty | The financial institution with which the issuer enters an interest rate exchange agreement. |
| Counterparty Risk | The risk that the other party in the derivative transaction fails to meet its obligations under the contract. |
| Credit Enhancement | A method that reduces credit risk by requiring collateral, letters of credit, insurance, or other agreements. |
| Credit Risk | An event that results in the decline of the University's or the counterparty's credit ratings. |
| Derivative | A financial transaction "derived" from an underlying asset, debt, index or reference rate. |
| Hedge | A transaction entered into to reduce exposure to market fluctuations. |
| Interest Rate Risk | The risk that interest rates will rise, on a sustained basis, above levels that would have been set if the issue had been fixed. |
| Interest Rate Swap | A transaction in which two parties agree to exchange future net cash flows based on predetermined interest rate indices calculated on an agreed notional amount. The swap is not a debt instrument between the issuer and the counterparty, and there is no exchange of principal. |
| LIBOR | The principal benchmark for floating rate payments for taxable issuers. The London Interbank Offer Rate is calculated as the average interest rate on Eurodollars traded between banks in London and can vary depending upon maturity (e.g., one month or six months). |
| Liquidity Facility | A bank or other financial firm, as liquidity facility provider, to temporarily act as owner of bonds (i.e., buy the bonds) in the event that holders tender bonds back to the issuer and the bonds cannot be successfully remarketed. |
| Liquidity Risk | The risk of having to pay a higher rate to the liquidity provider in the event of a failed remarketing. |

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| Rollover Risk | The risk that a swap maturity contract is not coterminous with the related bonds. In the case of the synthetic fixed rate debt structure, rollover risk means that the issuer would need to re-hedge its variable rate debt exposure upon swap maturity in incurring re-hedging costs. In the case of a liquidity facility, the risk of being unable to obtain a suitable replacement liquidity facility at a reasonable price upon completion or termination of a contract period. |
| Swap | A derivative that alters the cash flows of a debt obligation. An issuer's exposure to increasing interest rates arising from variable-rate debt may be hedged through a swap. |
| Tax Risk | The risk stemming from changes in marginal income tax rates due to the tax code's impact on the trading value of tax-exempt bonds. A form of basis risk. |
| Termination Risk | The risk that a swap will be terminated by the counterparty before maturity that could require the issuer to make a cash termination payment to the counterparty. Note: the issuer could have a termination payment even if the termination results from counterparty default. |
| Variable Rate Demand Bonds (VRDB) | A long-term bond for which the interest rate is reset periodically through a remarketing process. Bondholders have the option to "put" or "tender" the bond back to the issuer at interest reset dates. Put feature makes VRDB an eligible investment for money market funds. Requires liquidity facility in case of failed remarketing. |

Approved by BOV November 16, 2006