DEBT
(Adopted by the Board, Meeting #836, March 1, 2010.)

I. Overview

In support of their respective missions, Oregon University System (System) institutions each maintain a long-term strategic plan. These strategic plans establish university-wide priorities as well as university-wide and divisional programmatic objectives. Each System university develops a capital plan to support these priorities and objectives.

The System’s use of debt plays a critical role in ensuring adequate and cost-effective funding for the System institutions capital plans. By linking the objectives of its Debt Policy to its universities strategic objectives, the System ultimately increases the likelihood of achieving its mission.

II. Scope

The Debt Policy covers all forms of debt including long-term, short-term, fixed-rate, and variable-rate debt. It also covers other forms of financing including both on-balance sheet and other forms of financing that effectively operate as capital debt instruments even when not classified as such for financial statement purposes, such as certain operating leases and other structured products used with the intent of funding capital projects.

The use of derivatives is considered when managing the debt portfolio and structuring transactions. Conditions guiding the use of derivatives are addressed in a separate Interest Rate Risk Management Policy.

III. Objectives

The objectives of this policy are to:

a) Outline the System’s philosophy on debt
b) Establish a control framework for approving and managing debt
c) Define reporting guidelines
d) Establish debt management guidelines

The Debt Policy formalizes the link between the System universities Strategic Plans and the issuance of debt. Debt is a limited resource that must be managed strategically in order to best support System priorities.

The policy establishes a control framework to ensure that appropriate discipline is in place regarding capital rationing, reporting requirements, debt portfolio composition, debt servicing, and debt authorization. It establishes guidelines to ensure that existing and proposed debt
issues are consistent with financial resources to maintain an optimal amount of leverage, a strong financial profile, and a strategically optimal credit rating.

Under this policy, debt is being managed to achieve the following goals:

a) Maintaining access to financial markets: capital, money, and bank markets.
b) Managing the System’s credit rating (if applicable) to meet its strategic objectives while maintaining the highest possible creditworthiness that provides the most favorable cost of capital and borrowing terms;
c) Optimizing the System’s debt mix (i.e. short-term and long-term, fixed-rate and floating-rate, traditional and synthetic) for the System’s debt portfolio;
d) Managing the structure and maturity profile of debt to meet liquidity objectives and to make funds available to support future capital projects and strategic initiatives;
e) Coordinating debt management decisions with asset management decisions to optimize overall funding and portfolio management strategies;
f) Coordinating debt management decisions to maximize overall access to resources, including consideration of strategic opportunity costs, potential lost revenue, and interest and inflation rate tradeoffs.

System universities may use debt to accomplish critical priorities by prudently using debt financing to accelerate the initiation or completion of certain projects. As part of its review of each project, the university and the System will evaluate all funding sources to determine the optimal funding structure to achieve the most beneficial cost of capital.

IV. Oversight

The Vice Chancellor for Finance and Administration is responsible for implementing this policy and for all debt financing activities of the System. This policy is approved by the Board. The approved policy provides the framework under which debt management decisions are made.

The exposure limits listed in the policy are monitored on a regular basis by the Vice Chancellor for Finance and Administration. The Vice Chancellor for Finance and Administration reports regularly to the Chancellor, the Board, and the Internal Bank Oversight Committee on the System’s debt position and plans.

PRINCIPLES/GUIDELINES/PROCEDURES

V. Debt Affordability and Capacity

Project Viability:
All projects using self-generated revenues to repay the debt will be carefully reviewed to ensure that they are financially viable based on reasonable and prudent estimates of the revenues and expenses associated with each project or combination of similar projects. When determining whether a project meets the self-supporting requirements, the Board may take
into consideration the total available unobligated revenues of the university, or the System as a whole. This review process will include an analysis of the total cost of the project, including site preparation, environmental assessment/remediation, architectural and engineering costs, and construction, renovation or purchase costs. A financial pro-forma will be prepared by the university that estimates the revenues and expenses associated with the operations, maintenance and debt service of the project over the life of the bonds. Projected operating revenues will provide coverage of operating expenses, maintenance, and debt service. Sources and uses of funds should be identified as part of this analysis. The financial pro-forma will be reviewed by the Director of Treasury Operations prior to recommendation of projects to the Board.

**Institutional Concerns:**
Institutional financial viability will also be considered as part of the debt approval process. The institution must demonstrate that there is sufficient enrollment or research demand or other compelling needs or strategic opportunities to justify the investment in the project and to generate the resources for debt repayment. Three years of trend data will be considered as part of this analysis in order to demonstrate institutional financial viability over a series of years.

The following financial statement ratios will be considered in order to determine institutional financial viability as part of this analysis:

- **Primary reserve ratio** — unrestricted net assets / operating expenses
- **Current ratio** — current assets / current liabilities
- **Debt burden ratio** — annual debt service (principal + interest) / total operating expenses, with a guideline maximum debt burden ratio of 7 percent, as established by the Board

In addition to presenting the actual ratios computed for the prior three fiscal years, the university will be responsible for calculating pro-forma ratios to incorporate additional debt allocated during the current fiscal year as well as for other future proposed projects and to analyze this information together to determine financial viability.

The ratios and limits are intended to help the System universities maintain a competitive financial profile, funding for facilities needs and reserves, and compliance with System debt service to budget guidelines.

The Debt Policy is shared with external credit analysts and other parties in order to provide them with background on the System’s philosophy on debt and management’s assessment of debt capacity and affordability.

**VI. Real Property Financed by Third Parties**

In computing financial ratios, universities need to identify and incorporate information related to real property financed by third parties when by written agreement the university is obligated
to provide payments toward the property financing or to take over the financial obligation at a specified future date. Examples include agreements with an affiliated foundation and long-term capital leases. In determining whether long-term leases should be included when computing financial ratios, the institution must distinguish between capital and operating leases. Capital leases are considered debt, and must therefore be included in the ratios. Operating leases are not considered debt, and are therefore excluded from the ratio calculations.

Third-party financings may not include annual appropriation pledges of the State’s general fund, and long-term leases must comply with DAS administrative rules. In addition, third-party financings may not use the State’s credit or view the State as the underlying guarantor.

VII. Financing Sources

There are numerous types of financing structures and funding sources available, each with specific benefits, risks, and costs. All potential funding sources are reviewed by management within the context of the Debt Policy and the overall portfolio to ensure that any financial product or structure is consistent with the university’s and System’s objectives. Regardless of what financing structure(s) is utilized, due-diligence review must be performed for each transaction, including (i) quantification of potential risks and benefits, and (ii) analysis of the impact on System creditworthiness and institution debt affordability and capacity.

Tax-Exempt Debt

Tax-exempt debt is a significant component of the System’s capitalization due in part to its substantial cost benefits; therefore, tax-exempt debt is managed as a portfolio of obligations designed to meet long-term financial objectives rather than as a series of discrete financings tied to specific projects. The System manages the debt portfolio to maximize its utilization of tax-exempt debt relative to taxable debt whenever possible, keeping in mind potential issues related to the restrictions on the use of facilities financed with tax-exempt debt and the potential future uses of the facility(ies) being financed by the debt. In all circumstances, however, individual projects continue to be identified and tracked to ensure compliance with all tax and reimbursement regulations.

For tax-exempt debt, the System will consider maximizing the external maturity of any tax-exempt bond issue, subject to prevailing market conditions and opportunities and other considerations, including the useful life of financed facilities, future debt capacity of the System, applicable regulations, and the State Treasurer’s statewide debt portfolio management goals and policies.

Taxable Debt

In instances where certain of the System’s capital projects do not qualify for tax-exempt debt, the use of taxable debt may be considered. The taxable debt market offers certain advantages in terms of liquidity, marketing efficiency, and flexibility in the use of proceeds; such advantages will be considered when evaluating the costs and benefits of a taxable debt issuance.
Build America Bond Program
The American Recovery and Reinvestment Act (ARRA) of 2009 included provisions authorizing state governments to issue taxable bonds and receive an interest rate rebate in the amount of 35 percent of the interest paid from the Federal government (Build America Bond Program or BAB). This program opens up the taxable debt market to the System, which may prove to reduce borrowing costs. Bonds issued under this program must be treated in the same manner as tax-exempt debt with respect to the use of the bond proceeds (must be used for exempt purposes and follow the same private use rules as tax-exempt bond proceeds) and with respect to arbitrage rules. Accordingly, the System will manage debt issued under the BAB program as a part of the tax-exempt debt portfolio.

Commercial Paper
Commercial paper provides interim financing for projects in anticipation of philanthropy, planned issuance of long-term debt or from other sources of funds. The use of commercial paper also provides greater flexibility on the timing and structuring of individual bond transactions. This flexibility may also make commercial paper appropriate for financing equipment and as a tool to help manage the System’s short-term liquidity position. The amount of commercial paper is limited by the Debt Policy ratios, the System’s variable-rate debt allocation limit, and the System’s available liquidity support.

System-issued vs. Other State-issued Debt
In determining the most cost effective means of issuing debt, the System evaluates the merits of issuing debt “directly” (e.g., under Articles XI-G or XI-F(1) of the Oregon Constitution) vs. “issuing” debt through or a State-issuing entity (e.g., The Oregon Lottery, Certificates of Participation, or the State Energy Loan Program.)

When “issuing” debt through a State-issuing entity, the Legislature may appropriate funds to the System to repay the debt, or may appropriate funds to the State-issuing entity to repay the debt. Debt issued through a State-issuing entity will not be managed as a part of the debt portfolio, but will be managed discretely. Debt issued through a State-issuing entity is normally only available if authorized by the Legislature and is not available as an option unless so authorized.

System issued debt under Article XI-G of the Oregon Constitution is repaid by Legislative appropriation to OUS and is not managed as a part of the debt portfolio, but will be managed discretely.

In the case of debt that will be repaid by System-generated revenues, the System performs a cost benefit analysis between this financing option and others available and takes into consideration the comparative funding costs and the flexibility in market timing of each alternative. The System also takes into consideration the future administrative flexibility and financial options of each issue, such as the ability to call and/or refund issues at a later date, as
well as the administrative flexibility to structure and manage the debt in a manner that the System believes to be appropriate.

**Derivative Products**

Derivative products may enable more opportunistic and flexible management of the debt portfolio. Derivative products, including interest rate swaps and locks, may be employed primarily to manage or hedge the System’s interest rate exposure. The System, in consultation with the State Treasurer and in compliance with the State’s Interest Rate Swap Policy, utilizes a framework to evaluate potential derivative instruments by considering (i) its current variable-rate debt allocation, (ii) existing market and interest rate conditions, (iii) the impact on future financing flexibility, and (iv) the compensation for assuming risks or the costs for eliminating certain risks and exposure. Risks include, but are not limited to, tax risk, interest rate risk, liquidity risk, counterparty credit risk, basis risk, and any other potential risks either imposed or removed through the execution of any transaction.

The System analyzes and quantifies the cost/benefit of any derivative instrument relative to achieving desirable long-term capital structure objectives. Under no circumstances will a derivative transaction be utilized that is not understood fully by management or that imposes inappropriate risk on the System. In addition, management discloses the impact of any derivative product on the System’s financial statements per GASB (Governmental Accounting Standards Board) requirements and includes their effects in calculating the Debt Policy ratios.

**Other Financing Sources**

Given limited debt capacity and substantial capital needs, opportunities for alternative and non-traditional transaction structures may be considered, including off-balance sheet financings. The System recognizes these types of transactions often can be more expensive than traditional debt structures; therefore, the benefits of any potential transaction must outweigh any potential costs.

All structures can be considered only when the economic benefit and the likely impact on the System’s debt capacity and credit have been determined. Specifically, for any third-party or developer-based financing, management ensures the full credit impact of the structure is evaluated and quantified.

**VIII. Compliance with IRS Regulations**

When tax-exempt governmental-purpose bonds are issued, the System must comply with all applicable IRS regulations including, but not limited to, regulations relating to the use of bond proceeds, the use of bond-financed facilities, and arbitrage in order to maintain the bonds’ tax-exempt status.
IX. Portfolio Management of Debt

For purposes of this section, the System’s debt portfolio is defined as debt issued under Article XI-F(1) of the Oregon Constitution (XI-F debt). The System considers its debt portfolio holistically, that is, it optimizes the portfolio of debt for the entire System rather than on a project-by-project basis while taking into account the System’s cash and investment portfolio. Therefore, management makes decisions regarding project prioritization, debt portfolio optimization, and financing structures within the context of the overall needs and circumstances of the universities of the System.

Variable-Rate Debt

Exposure to variable interest rates within the System’s debt portfolio may be desirable in order to:

a) take advantage of repayment/restructuring flexibility;
b) benefit from historically lower average interest costs;
c) reduce financial interest rate risk by providing a “match” between debt service requirements and the projected cash flows from the System’s assets; and
d) diversify its pool of potential investors and gain additional access to the capital markets.

Management monitors overall interest rate exposure, analyzes and quantifies potential risks, including interest rate, liquidity and rollover risks, and coordinates appropriate fixed-variable allocation strategies. The portfolio allocation to variable-rate debt may be managed or adjusted through (i) the issuance or redemption of debt in the conventional debt market (e.g., new issues and refundings) and (ii) the use of interest rate derivative products including swaps.

The amount of variable-rate debt outstanding (adjusted for any derivatives) shall not exceed 20 percent of the System’s outstanding XI-F debt. This limit is based on the System’s desire to: (i) limit annual variances in its interest payments, (ii) provide sufficient structuring flexibility to management, (iii) keep the System’s variable-rate allocation within acceptable external parameters, and (iv) utilize variable-rate debt (including derivatives) to optimize debt portfolio allocation and minimize costs.

\[
\text{VARIABLE-RATE DEBT (INCLUDING SYNTHETIC)} \leq 20\%
\]

Refinancing Outstanding Debt

The System monitors its debt portfolio on a continual basis to assure portfolio management objectives are being met and to identify opportunities to lower its cost of funding, primarily through refinancing outstanding debt.

The System monitors the prices and yields of its outstanding debt and attempts to identify potential refunding candidates by examining refunding rates and calculating the net present
value of any refunding savings after taking into account all transaction costs. The System may choose to pursue refundings for economic and/or legal reasons. The System currently adheres to the State of Oregon’s refunding thresholds. Net Present Value (NPV) savings of 3 percent or otherwise as permitted by the State Treasurer.

**Liquidity Requirements**

The System’s portfolio of variable-rate debt and commercial paper require liquidity support in the event of variable rate demand bonds being put back to the System or the Commercial Paper maturing without new investors. Generally, the System can purchase liquidity support externally from a bank in the form of a standby bond purchase agreement or line of credit. In addition, the System can also use its own capital or the capital available to the State Treasurer (if approved) in lieu of or to supplement external facilities. Alternatively, it can utilize variable-rate structures that do not require liquidity support (e.g., resetting variable rate term loans).

Just as the System manages its debt on a portfolio basis, it also manages its liquidity needs by considering its entire asset and debt portfolio, rather than managing liquidity solely on an issue-specific basis. This approach permits Systemwide evaluation of desired liquidity exposure, provides administrative flexibility, and reduces total liquidity costs.

A balanced approach is used to provide liquidity support to enhance credit for variable-rate debt, through a combination of external bank liquidity, self-liquidity, and other financial tools. Using a variety of approaches limits dependence on an individual type or source of credit; it also increases access to different types of investors. The System must balance liquidity requirements with its investment objectives and its cost and renewal risk of third-party liquidity providers and internal capacity.

Further, a portfolio-approach to liquidity can enhance investment flexibility, reduce administrative requirements, lower total interest costs, and reduce the need for external bank liquidity.

**Overall Exposure**

The System may be exposed to interest rate, third-party credit, tax (the risk that the tax code may change in future periods and impact the cost or financial result of certain debt instruments), and other potential risks in areas other than direct System debt (e.g., off-balance sheet transactions, counterparty exposure in the investment portfolio, etc.) and, therefore, exposure will be measured and monitored on a comprehensive Systemwide basis.

The chart below attempts to visually display the interplay of risks that may be present depending on the types of debt instruments employed. For instance, when using variable rate debt, interest rate risk increases for obvious reasons. For less obvious reasons, if the System utilizes third-party liquidity to support its variable rate debt, the risk of the credit-worthiness of the liquidity provider comes into play. Additionally, income tax risk is interjected when variable rate bonds are remarketed as the tax laws may change and impact the cost of carrying the variable rate debt. If the System were to convert that variable rate debt to fixed via an interest
rate swap agreement, the interest rate risks would be mitigated, but the risk of the credit-worthiness of the third-party liquidity provider would not.

![Diagram showing interest rate risk and liquidity requirement for different types of bonds]

X. **Central Loan Program Management**

For purposes of this policy section, the central loan program pertains only to proceeds of XI-F debt or internal liquidity.

Each institution is responsible for the repayment of all funds borrowed from the central loan program, plus interest and any fees established in the System’s internal lending policies, regardless of the internal or external source of funds.

Loan structures with standard financial terms are offered to institutional borrowers. The System may provide for flexible financing terms in order to accommodate individual institutional needs if it is determined to be in the university’s and System’s best interest. The Vice Chancellor for Finance and Administration will clearly articulate the policies and procedures for the assumption and repayment of debt to all borrowers. The Director of Treasury Operations is the System’s loan officer for institutional borrowers.

**De-linking External and Internal Debt Structures**

The System has adopted a central loan program under which it provides funding for projects across all institutions under the guidance of the Vice Chancellor for Finance and Administration. In this regard, the System has established a pool of financing resources, including debt, for a central source of capital.
The benefits of this program include:

a) Enabling the structuring of transactions in the best economic interests of the System that might not be possible on a project-specific basis,
b) providing continual access to capital for borrowers,
c) permitting the System to fund capital needs on a portfolio basis rather than on a project-specific basis,
d) funding specific projects with predictable financial terms,
e) achieving a consistently low average internal borrowing costs while minimizing volatility in interest rates,
f) permitting prepayment of internal loans without penalty, and
g) achieving equity among borrowers through a blended rate.

The diagram below outlines the relationship between the System's internal borrowers, the central loan program, and the external debt market for debt that is repaid via system-generated revenues:

The central loan program can access funds from a variety of sources to originate loans to institutions. The System manages its funding sources on a portfolio basis, and therefore payments from institutions are not tied directly to a particular source of funds. (Note: due to federal tax and reimbursement requirements, actual bond debt service for certain projects still must be tracked.)

**Blended Interest Rate**
The System charges a blended interest rate to its institutions based on its cost of funding. In some instances, at the discretion of the Vice Chancellor for Finance and Administration, the type and useful life of the project being financed may affect the appropriate term and interest rate of any loan.
This blended interest rate may change periodically to reflect changes in the System’s average aggregate expected long-term cost of borrowing. The blended interest rate may also include a reserve for interest rate stabilization purposes.

In addition to charging borrowers interest, the central loan program collects amounts to pay for costs of administering the debt portfolio. These costs are clearly articulated to institutions, and are passed on to borrowers in the form of a rate surcharge and an upfront fee for loan origination. These charges may be reviewed and adjusted from time-to-time.

X. Approval Process

The System, through the Oregon State Treasury, issues debt under Articles XI-F(1) and XI-G of the Oregon Constitution. The System may also enter into other financing agreements (e.g., capital leases) with external entities for amounts in excess of $100,000 with the approval of the State Treasurer and the Director of the Oregon Department of Administrative Services (DAS). Should the System be granted authority in the future to establish a revenue bond program, it is anticipated that such debt would be issued through the Oregon State Treasury as well.

All debt issued by the System must be authorized through a board resolution (or the Finance and Administration Committee as authorized by the board). When the System issues debt under Article XI-F(1) of the Oregon Constitution, the board’s authorizing resolution must include its finding, based on the analysis of debt affordability and capacity delineated in section IV above, that the XI-F(1) debt financed projects are both self-liquidating and self-supporting.

The Board delegates the authority to approve the pricing of System-issued debt to the Vice Chancellor for Finance and Administration.

Other State-issued debt is approved as follows:

- DAS issues Certificates of Participation on behalf of the System.
- The Oregon Lottery issues Lottery bonds on behalf of the System.
- The Oregon Department of Energy loans money to System institutions for energy savings projects.

When the System participates in debt programs that are administered by other State agencies, such bonds are issued by the State Treasurer who also possesses the authority to price such bonds.

XII. Policy Conflicts

The provisions of this policy will supersede conflicting policy provisions in other Internal Management Directives, board policies, and/or other fiscal policies.
INTERNAL BANK

(Adopted by the Board at Meeting #836, March 1, 2010; amended, Meeting #843, October 8 2010)

In order to more efficiently and effectively carry out the treasury management function within the Oregon University System (System), the Board has established within the Chancellor’s Office an internal bank. The internal bank will operate in perpetuity and will integrate the three primary functions of treasury management within the System: limited term investment management (the management of non-endowment investment assets), debt management (both short- and long-term) and cash management (transaction and process management). In order to effectively integrate these functions, the following policies are established:

- The cash balances (limited term assets) of each institution and the Chancellor’s Office are pooled for investment purposes and the internal bank is charged with the responsibility to manage the processing and investment of those funds to maximize investment returns within a prudent level of risk while assuring necessary liquidity.

- Financing necessary for approved System capital purchases (including lease purchases) and capital construction projects that will be repaid by System-generated resources (tuition & fees and other self-generated revenues) is provided by the internal bank to System institutions through a central loan program.

- The System’s Article XI-F(1) debt is managed in a portfolio approach and the internal bank is charged with the responsibility to manage the System’s XI-F(1) debt portfolio to minimize the System’s cost of capital within a prudent level of risk.

The purpose of the Internal Bank is to facilitate the long-term financial stability of the System though effective asset/liability management strategies and optimizing the organization’s capacity to access the capital markets in the amounts needed at a reasonable price.

The operation of the internal bank will comply with all applicable federal and state statutes, rules and policies. Accordingly, the internal bank will coordinate and cooperate with the Oregon State Treasury and the Department of Administrative Services in making investment and debt financing decisions.
PRINCIPLES/GUIDELINES/PROCEDURES

Management of the Internal Bank
The Internal Bank will be managed by the Director of Treasury Operations who will report to the Vice Chancellor for Finance and Administration through the Associate Vice Chancellor for Finance and Administration and Controller. The Director will employ a staff to provide the services that align with the goals of the Internal Bank, including other related services that the campuses desire to purchase from the internal bank. Payment for management of the activities of the Internal Bank will be paid out of the Internal Bank’s income, generated by interest rate spreads, service fees, and by moneys so appropriated by the State Legislature. Payment for specific services that are provided by the Internal Bank on an institution by institution basis, such as bank account reconciliation services, will be paid by each institution separately.

The Director of Treasury Operations will be responsible for:

- Establishing the internal deposit interest rate
- Establishing the internal lending rate
- Establishing and maintaining the internal lending program
- Management of the System’s operating asset investment and long-term debt portfolios
- Developing and maintaining related internal control processes and procedures
- Accounting for the operation of the Internal Bank
- Developing financial and other performance monitoring reports
- Developing and implementing operating policies and procedures
- Developing and managing the annual operating budget of the Internal Bank
- Maintaining access to adequate liquidity sources to meet the needs of the System and its universities

The Director of Treasury Operations, in coordination with the State Treasurer’s Office will contract with a professional financial advisory firm to assist with the management of the investment and debt portfolio as appropriate and bond counsel to assist with the management of the debt portfolio.

At least quarterly, the Director of Treasury Operations will report to the Internal Bank Oversight Committee (see below) on the financial and operating performance of the Internal Bank. These reports would include the operating budget, financial statements and any other performance reports needed to evaluate the Internal Bank’s financial performance and the achievement of its long-term goals.
Transactions Undertaken by the Internal Bank

The Director of Treasury Operations will make recommendation to the Board’s Finance and Administration Committee regarding the following transactions of the Internal Bank:

1. Investments of operating assets that fall outside the parameters of the Board-approved operating funds management policy or related policies
2. Issuances of debt including:
   a. Commercial paper for XI-F capital projects that have been approved for debt financing by the Legislature and OUS Board
   b. Long-term debt for XI-F capital projects that have been approved for debt financing by the Legislature and OUS Board
3. Transactions undertaken to manage the debt portfolio including:
   a. Refunding outstanding debt pursuant to the State Treasurer’s refunding guidelines
   b. Structural refinancing of the debt portfolio
   c. Issuances of derivative financial instruments, including interest rate swap agreements

Recommended investment and debt transactions that are approved by the Board may also need approval by the State Treasurer and/or the Department of Administrative Services.

Deposit Interest Rate

The Director of Treasury Operations, working with the Internal Bank Oversight Committee, will develop the policy that establishes the interest rate to be credited to institution accounts based on market conditions. The rate will be evaluated and adjusted as necessary.

Internal Lending Rate

Annually, the Director of Treasury Operations, working with the Internal Bank Oversight Committee, will establish the internal loan program interest rates. Different interest rates will be established for different internal loan durations. It is the goal and objective to establish those rates to remain in perpetuity. However, it is understood that, should the capital markets behave in an unanticipated manner and the reserves available to the Internal Bank are projected to become depleted or excessively large, the internal loan program interest rates may be modified on all internal loans outstanding, including loans that relate to financings undertaken before the establishment of the Internal Bank. This is critical to ensure that the interest rate adjustment is equitable across the System and is not unfairly applied to only the projects that were financed subsequent to the establishment of the Internal Bank.

Internal Bank Reserves

The Internal Bank may build and maintain an Interest Rate Reserve to hedge future volatility in the debt markets by charging a spread between the investment income generated on operating cash balances and the amount credited to institution accounts and/or by charging a spread between the internal lending rates charged for financing Board-approved self-supporting and self-liquidating projects and the blended cost of the outstanding debt portfolio. The Interest
Rate Reserves shall not be maintained at a level higher than needed to appropriately hedge future interest rate volatility. Should the Interest Rate Reserve exceed the necessary level, the internal deposit and/or lending rates may be adjusted either temporarily or permanently to reduce the reserve to the proper level. The Interest Rate Reserve may not be used for any other purpose without the approval of the Board’s Finance and Administration Committee.

The Finance and Administration Committee may establish additional reserves to be held by the Internal Bank that align with its goals and objectives. The purpose and uses of such reserves will be clearly delineated within this policy.

**Additional Policies to Guide and Control the Operation of the Internal Bank**

The policies that guide and control the operations of the bank and limit financial risk to the System include, but are not limited to:

- An operating funds management policy that provides guidance in the investment of the System’s operating assets and the management of the System’s liquidity
- A debt policy that provides guidance in the issuance of debt and the ongoing management of the debt portfolio of the System
- An interest rate risk policy that provides control over the types and nature of derivate financial instruments that may be utilized by the Internal Bank

These policies will be reviewed by the Board’s Finance and Administration Committee at least once every two years.

**Transparency and Accountability**

Transparency and accountability will be a key objective of the management and operation of the Internal Bank. All income and expenses of the Internal Bank will be reported to the Internal Bank Oversight Committee via periodic financial statements. All investment and debt transactions and all internal lending transactions will be reported to the Internal Bank Oversight Committee, along with reports on the System’s risk position, hedging activities, and compliance with related policies.

**Internal Bank Oversight Committee**

To help ensure that the goals and objectives of the Internal Bank are being met and in order to foster accountability and transparency with respect to the activities of the Internal Bank, there is established an Internal Bank Oversight Committee (Oversight Committee). The Oversight Committee is made up of the Vice Presidents for Finance and Administration of each of the campuses, or his/her designee, and will be chaired by the Vice Chancellor for Finance and Administration. The role of the Oversight Committee is to review and evaluate the financial and operating performance of the Internal Bank and to work with the Director of Treasury Operations to establish:

- Deposit and internal loan interest rates and related policies,
- Fees and related policies,
- Operating policies for the Internal Bank, and
- The operating budget of the Internal Bank.
Meetings of the Oversight Committee will be held at least quarterly, at which time the Director of Treasury Operations will present the operating budget, financial statements and any other performance reports needed to evaluate the Internal Bank’s financial performance and the achievement of its long-term goals.

The role of the Oversight Committee does not include the approval of individual campus capital projects. That role remains the sole purview of the Board.

**Policy Conflicts**
The provisions of this policy will supersede conflicting policy provisions in other Internal Management Directives, Board policies, and/or other fiscal policies.

**RESIDENCE HALL EMERGENCY RESERVE FUND**
The purpose of the Residence Hall Emergency Reserve Fund (Reserve) is to provide for unanticipated financial emergencies in the residence hall operations, which could otherwise affect the ability of a single institution to support the payment of its debt service obligations. The Reserve may also be used to supplement the Interest Rate Reserve of the Internal Bank. The Reserve shall not be a supplemental source of funds that may be considered or relied upon when planning for the financing of construction, renovation, or repair/upgrade of projects. Each institution must have a business plan in place addressing current and future needs of its student housing operations and how it intends to fund those needs through institutionally-initiated efforts. The provisions of this policy, described in sections 1 through 4, shall apply to residence hall operations at residence and dining facilities other than at Portland State University. The provisions in section 4 will apply to the Internal Bank when requesting temporary use of the Reserve to supplement its Interest Rate Reserve.

(1) Specific Provisions:

a. The Reserve will be funded by an institutional payment equivalent to twenty dollars ($20) per occupant, per year, based on the number of students living in the residence halls referenced in section 6.300(1)(a).

b. The number of students for purposes of (a) shall be determined by the prior year three-term average residence hall occupancy as of the fourth week of each term. (An "occupant" is any student living in a residence hall who is not a residence hall director.)

c. Institutional payments to the Reserve will be made by May of each year beginning in fiscal year 1999-00. All payments to the Reserve will be monitored by the Chancellor’s Office with a record kept of payments made by each institution.

(2) Institutional payments to the Reserve will be made for eight (8) fiscal years, 1999-00 through 2006-07

---

5 IMD 6.316 repealed, Meeting #836, 3/5/2010, and transferred to Internal Bank Policy
(3) Interest earnings of the Reserve, if any, will accrue to the Reserve. Distribution of interest earnings will be determined by the Board.

(4) Authorization for use of funds from the Reserve shall require a written application and comprehensive business plan from the requesting institution or the Internal Bank. The application and business plan shall be submitted to the Vice Chancellor for Finance and Administration for approval.
INTEREST RATE RISK MANAGEMENT

(Adopted by the Board at Meeting #843, March 1, 2010)

I. Overview

The Oregon University System (System) maintains a Debt Policy which sets forth guidelines on the authorization and management of debt. The System manages its debt issued under Article XI-F(1) of the Oregon Constitution (XI-F debt) on a consolidated, portfolio basis and makes debt management decisions to achieve the lowest cost of debt capital and maximize its portfolio objectives. The nature of managing debt as a portfolio implies that there may be a mismatch of the specific terms on either side of the balance sheet. These mismatches may include maturity, payment schedule, interest rate, etc. These mismatches cause interest rate risk that may affect cash flow or the value of the underlying debt and corresponding loan. The use of derivatives can play a key role in managing the interest rate risk associated with the System’s debt portfolio and other managed portfolios.

In certain circumstances, derivatives are an effective way for the System to adjust its mix of fixed- and floating-rate debt and manage interest rate exposures. Derivatives may also be an effective way to manage liquidity risks. The System’s philosophy is to use derivatives strategically to achieve asset and liability portfolio objectives and hedge existing exposures. Derivatives will not be used to create leverage or to speculate on the movement of interest rates.

II. Scope

The Interest Rate Risk Management Policy applies to any derivatives used for the purpose of hedging interest rate exposures. This policy does not apply to derivatives used by the State Treasurer’s office in its management of the System’s endowment and assets of any System university-related foundations.

Additionally, any decisions made regarding the use of derivatives must take into consideration the resulting impact under the System’s Debt Policy.

III. Objectives

This policy is intended to:

(i) Outline the System’s philosophy on derivatives
(ii) Provide guidelines on the use of derivatives
(iii) Identify approved derivative instruments
(iv) Establish a control framework related to the use of derivatives
The System views derivatives as a tool to achieve its asset and liability management objectives. As a result, it is the System’s philosophy to use derivatives strategically in support of this cause. It is also the System’s philosophy to not use derivatives to create leverage or speculate on interest rate movements. The System recognizes that the prudent and selective use of derivatives may help it to lower its cost of debt capital and manage its interest rate exposure.

This policy provides guidelines on the use of derivatives including the circumstances under which they may be used and the factors that are considered in deciding whether to use them. Derivatives may be used to achieve the following objectives:

(i) Reduce the cost for debt financing when compared to conventional debt structures
(ii) Manage interest rate volatility
(iii) Manage fixed- and variable-rate debt mix
(iv) Help match the cash flows from assets with those from liabilities
(v) Hedge future debt issues or synthetically advance refund bonds

The policy also outlines a control framework to ensure that an appropriate discipline is in place regarding the use of derivatives. Controls exist to address both operational risks and exposure risks.

IV. Oversight

The Vice Chancellor for Finance and Administration (VCFA) is responsible for coordination with Oregon State Treasury in implementing this policy and for all interest rate risk management activities of the System. The policy and any subsequent, material changes to the policy are approved by the Board’s Finance and Administration Committee (F&A Committee).

The VCFA provides oversight and monitors all derivative transactions. The Director of Treasury Operations reports on all derivative transaction, at least quarterly, to the Internal Bank Oversight Committee (Oversight Committee) and at least annually to the Chancellor and the F&A Committee on the System’s outstanding derivatives.

V. Derivative Use Guidelines

The System may use derivatives to achieve a lower cost of debt funding, manage its exposure to interest rate volatility, and/or match the timing and nature of cash flows associated with its assets and liabilities. The System may accomplish this by hedging the interest rate volatility of projected debt issuances or by using derivatives to adjust its exposure to variable interest rates.

To determine its portfolio exposure, the System looks at the composition of its outstanding assets and liabilities (adjusted for any hedges) and the change in this composition over a predetermined planning horizon. Taking into account the potential for future uncertainty, the
System determines what, if any, action should be taken to keep its portfolio exposures at desirable levels over this period.

In determining when to hedge, the System monitors its interest rate exposure, the capital markets, and its future funding and liquidity requirements. Special attention is paid to the relative level of interest rates, the shape of the yield curve, and signals of interest rate increases or decreases from the Federal Reserve.

The System analyzes and quantifies the cost/benefit of any derivative instrument relative to achieving desirable long-term capital structure objectives. Before entering into a derivative, the System evaluates its risks including, but not limited to: tax risk, interest rate risk, liquidity risk, credit risk, basis risk, rollover risk, termination risk, counterparty risk, and amortization risk.

When evaluating its hedging options, the System generally prefers the lowest cost, most liquid, and most flexible hedging strategy available. In instances where no one hedging strategy meets all these needs, the System prioritizes these requirements to decide on an optimal strategy.

At their inception, derivatives are chosen to closely match the exposures being hedged. As time passes, the System’s debt management objectives may change and any decisions will be made with the best information available at that time regardless of hedges that may be in place. For instance, the System may use derivatives to hedge future interest rates associated with a fixed-rate bond issuance. If at the time of issuance it is deemed more beneficial to issue floating-rate bonds, then the System will not let its past hedging decisions constrain its current bond issuance decisions.

In addition, management discloses the impact of all derivatives on the System’s financial statements per GASB requirements and includes their effects in calculating the financial ratios identified in the System’s Debt Policy.

The Oversight Committee will set acceptable risk tolerances for each portfolio, which will determine whether adequate hedging has occurred.

VI. Allowable Derivative Instruments

The System recognizes that there are numerous derivatives of varying degrees of complexity. The System attempts to avoid structural complexity in its use of derivatives and believes the following instruments, used alone or in combination with each other, allow for sufficient flexibility to help the System meet its interest rate risk management objectives.

**Interest Rate Swaps** – Swaps are contracts to exchange payments based on different interest rate indices, generally with one such index based on interest rates that are fixed at a specific rate for the term of the contract and the other based on interest rates that are to be adjusted from time to time throughout the term of the contract. The System may utilize these contracts
to change its mix of fixed rates and floating rates to achieve optimal asset-liability balance. They may also be used as a means to hedge future variable rate financings.

**Interest Rate Call or Put Options** — An option gives the holder a right, but not an obligation, to buy or sell a security at or by a specified date(s) at an agreed upon price in exchange for the payment of a premium. Interest rate options, typically in the form of interest rate caps and/or floors, are designed to provide protection against interest rates being above a certain cap rate or below a certain floor rate. Options may be used when the purchaser faces an asymmetrical risk profile, for instance, the risk that interest rates may rise prior to a new debt issuance. Options to enter into swaps, or swaptions, give the buyer the right to enter into a swap as a fixed-rate or floating-rate payer depending on the buyer’s interest rate exposure.

The System will not sell options, except to the extent they are sold to better hedge an underlying exposure that contains an offsetting option position. For example, a bond with a call option held by the System may be hedged better by entering into a derivative with an offsetting sold call option.

**Interest Rate Locks** — A rate lock is a forward contract that represents a sale of a specific benchmark security (e.g., U.S. Treasuries, LIBOR, or tax-exempt indices) or other appropriate benchmark security at an agreed price or interest rate. The System may utilize these contracts to help lock in a future financing rate.

Before entering into any derivative transaction, the System first gains a full understanding of the transaction and performs appropriate due diligence, such as (i) a quantification of potential risks and benefits, and (ii) an analysis of the impact on the System’s debt portfolio. The duration of each derivative may be different from the duration of the risk being offset.

### VII. Policy Controls

The System has established both operating and exposure controls to address program risks.

**Operating Controls**

When utilizing derivatives, it is important for operating controls to be in place to provide for adequate segregation of duties and management oversight. The System has controls addressing trade initiation, approval, confirmation, and accounting.

Appendix A to this Policy lists the individuals who may enter into derivatives on behalf of the System. These individuals may not approve their own transactions, unless explicitly stated in Appendix A. Initiators may not confirm transactions with counterparties and may not enter the accounting related to a trade. These controls are in place to assure trades are fully disclosed, accounted for, and approved by appropriate parties.
Appendix A also contains a list of individuals with authority to approve transactions. In all instances, unless provided for in Appendix A, an approver may not also be the initiator for a specific transaction.

Confirmations serve the purpose of confirming the details of a trade as understood by the System and its counterparty. Trade confirmations are done by an individual who does not have authority to either initiate or approve transactions.

Transactions are recorded for accounting purposes by an individual who is neither the initiator nor the approver. This segregation helps to assure that trades are accounted for correctly and are recorded and valued correctly on an ongoing basis.

**Exposure Controls**

The System manages its derivatives exposure by looking at its derivatives portfolio independently and also in the context of its overall asset and liability portfolios. Prior to entering into a derivative transaction, the System will examine the impact of such trade independently and on the asset and liability portfolios as a whole. The System will also coordinate this review with the financial advisor contracted by the State Treasurer pursuant ORS 286A.132(a).

All derivatives will be monitored by the State Treasurer’s financial advisor to provide valuations of the derivatives and monitor compliance with the terms and conditions of the derivative contract.

Appendix B to the policy establishes limits related to counterparty credit ratings, and the maximum allowable percentage of floating rate debt.

Exposure controls are in place to limit the System’s exposure to the various market risks associated with derivatives.
Appendix A

OPERATING CONTROLS

**Authorized Initiators** — The individuals holding the following positions are hereby authorized to initiate interest rate derivative transactions on behalf of the System:

- Chancellor
- Vice Chancellor for Finance and Administration
- Associate Vice Chancellor for Finance and Administration and Controller
- Director of Treasury Operations

**Approval** — All interest rate derivative transactions on behalf of the System must be approved by both:

- The Board’s Finance and Administration Committee, and
- The Director of Debt Management, Oregon State Treasury
Appendix B

EXPOSURE CONTROLS

**Maximum Percentage of Floating Rate Debt** — The System’s outstanding debt portfolio will have no more than 20 percent of the principal amount in floating rate debt, as described in its Debt Policy. This percentage is calculated to factor in the effects of interest rate derivatives.

**Counterparty Credit Exposure** — All derivative counterparties will be rated A3 or better by Moody’s and A– or better by Standard & Poors. The maximum allowable credit exposure, determined by the net mark-to-market of all trades with a single counterparty, will be $25 million for counterparties rated Aa2/AA or better and $10 million for counterparties rated less than Aa2/AA.

The System may take steps to reduce its exposure to a counterparty by either (i) requiring the counterparty to post collateral in the full amount of the exposure (all the while abiding by the terms of any Credit Support Annex between the System and the counterparty), (ii) terminating all or a portion of its outstanding contract(s) with the counterparty, or (iii) requiring the counterparty to obtain swap insurance or provide another form of third-party security agreeable to the System.

The System will also strive to limit counterparty exposure to no more than $100 million per notional amount with the strategy of diversifying the use of counterparties. In determining counterparty credit exposure, the System will also consider the counterparty’s credit exposure to other System related organizations (e.g., related university foundations.)

**Measuring Exposure** — The internal bank will compute the overall interest rate risk exposure faced by the internal bank within 90 days after each debt issuance and no less frequently than once per year. The internal bank may use its own computational models to compute this risk or contract with a third party to supply this information.