Appendix to Financial Institutional Policy VI – 130

Internal Loan Policy for Capital Construction & Renovation Projects — "Capital Lending Program"

March 2016

Overview

The Indiana University Office of the Treasurer has created the IU Capital Lending Program (CLP); which replaces the internal loan process, effective January 1, 2016. Existing internal loans will continue to pay down as previously contracted.

CLP Goals/Objectives

- Continue to reduce the university's overall cost of capital
- Eliminate inequities in the cost of capital between university schools, units, and departments
- Reduce interest rate risk taken on by schools and departments

All non-student fee capital and renovation projects will be financed through the CLP (unless the department finances the project with its own reserves or fully-received gifts). The CLP will provide loans for projects with terms up to 25 years, depending on the nature of the project. The Office of the Treasurer will evaluate project viability based on IU's *Institutional Credit Guidelines* Project-Specific Credit Assessment Requirements, which evaluate whether the unit can support interest and principal payments through signed gifts, reserves, and sources of future income. Project evaluation will also include analysis of use of the project, key financial risks and the overall impact on the university's debt portfolio and creditworthiness.

The structure of the CLP program follows best practices of other institutions with similar programs such as the Ohio State University, University of Virginia, Stanford University, University of Washington and others.

Interest Rates/Early Repayment

Lending under CLP will continue to be called loans. All CLP loans over two years in duration will have level, mortgage-style, near fiscal year end debt service payments, with a fixed interest rate. Borrowers will also have a short term option of two years or less with a variable rate. Loans over two years in duration must be at least $500,000. Loans less than two years must be at least $250,000.

CLP Initial Interest Rate Schedule

- 2 years or less: Variable Rate + 100 bps*
- 0-10 years: 4.25%
- Over 10 years: 4.75%

* Variable Rate will be based on Office of Treasurer cost of borrowing at time of execution of internal loan

The above rates are set at a level that the CLP could weather changes in interest rates in external markets over several years. If changes are made to the rate schedule, they will occur in concert with the

University budget construction cycle. These rates are also at levels which are consistent with other higher education institutions with similar programs (see Exhibit B).

Early repayment is allowable. However, since loan activity may correspond to external financings, early repayment must be discussed with the Treasurer at least 90 days in advance.

Debt Service Requirements

All CLP loans will require the units to set aside funds equal to 0.25 times maximum annual debt service (MADS) during the life of the loan as a debt service reserve. This level is consistent with current University practice. The CLP will hold additional liquidity in the debt service reserve from the Indiana University Operating Funds equal to 0.75 times maximum annual debt service. Therefore, total funds in the debt service reserve will equal 1.0 times maximum annual debt service.

Accounting

Accounting for the CLP will follow a hybrid of the Commercial Paper procedure at variable rates and the existing internal loan program for the funding portion of the debt. Note that all CLP activities (borrowing, loans, interest expense, and interest income, if any) will reside in applicable 70* accounts. For financial reporting purposes, IU's external borrowing rate will be utilized.

CLP Financing Approach

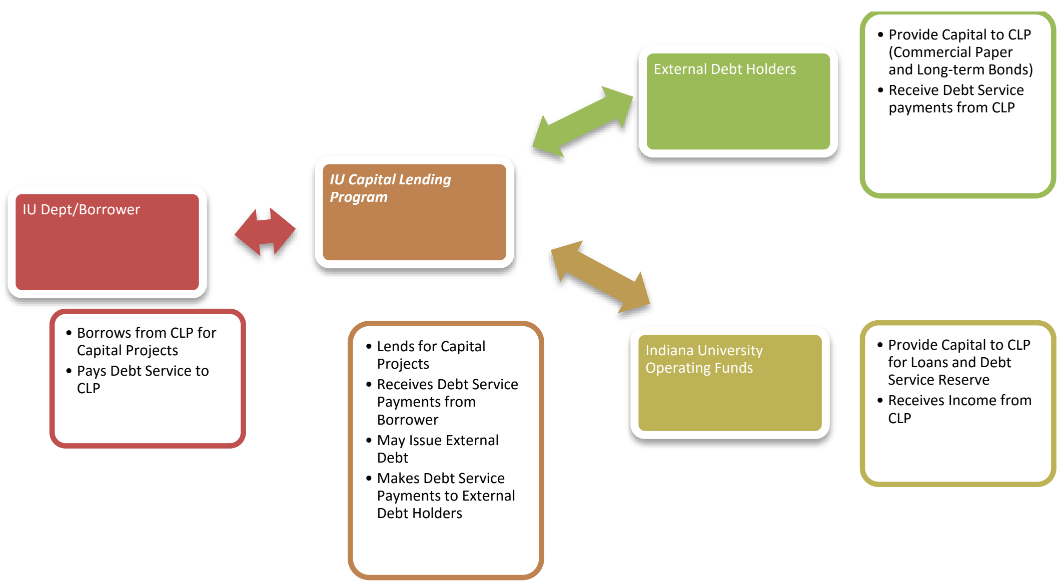
The CLP will have two sources of capitalization. The main source of capital will be via the issuance of external debt, typically commercial paper (CP) or fixed rate bonds. CP is a short term debt instrument commonly used to provide liquidity during construction periods of capital projects. CP may be outstanding for up to 270 days, at which time it is remarketed for up to another 270 days. Under normal market conditions, this process replicates again and again. CP offers considerable flexibility, as it is relatively easy to either increase the amount outstanding on any business day or of decrease the amount outstanding when the short term maturity becomes due. Long term bonds, which IU has issued exclusively since 2008, take several months to issue with greater up-front fixed costs and prepayments are not commonplace and depend on the ability to call bonds and refund based on tax-exempt financing rules.

Upon approval of a loan to a unit, the CLP will analyze and determine the most effective manner to finance the project. In most cases, the CLP will issue CP equal to the amount of the loan, but this will be based on loan bundling as the marketplace expects certain issuance amounts. The CP will then remain outstanding during the construction period of the project or until such time the CLP determines it is most appropriate to refund the CP outstanding by issuing long term bonds. Alternatively, in some cases, the CLP may choose to issue longer term bonds to permanently finance the project.

Current CP interest rates are between 15-25 basis points (depending on length of maturity) for highly rates issuers, such as Indiana University. However, variable interest rates are subject to sudden spikes and changes based on where short term rates relative to long term rates are at in the marketplace. By adding CP to IU's debt portfolio for projects in their construction period, IU will realize an interest rate that is 2-3% lower than immediately issuing long term debt. For every $100 million of CP outstanding, this will translate into $2 to $3 million in financing savings to the university. Since CP carries a variable interest rate, it is appropriate to set limits on the amount outstanding at any time to mitigate interest rate risk. The CLP will not issue variable rate debt at a level more than approximately 20% of the total amount of debt outstanding for the university at any time. Currently, IU has approximately $950 million total debt outstanding, therefore the CP limit would be up to and including $190 million.

The second source of capital will be liquidity from IU's Operating Funds. At any time, IU maintains between $1.5 and $2.0 billion in cash and investments to support operations. These funds are in a variety of financial vehicles, from cash and very liquid short term instruments to various fixed income investments with longer durations which provide a return on the university's funds while taking on a measured amount of risk. CLP may utilize up to 0.7% of IU's Operating Funds for borrowing activity, which was the prior threshold for internal loans.

<u>CLP Structure</u> <u>(Exhibit A)</u>



Note: An additional option available to borrowing units it to initially borrow from CLP with a term of two years or less to take advantage of the lower variable rate during construction. Post construction, the school may refinance at a fixed rate. This option may be of benefit in situations where the borrowing unit will not have incremental revenue until after completion of the project.

<u>Strategic Rationale</u>

The prior internal loan program provided an interest rate advantage to that of external debt (long term bonds) which resulted in disparity among units depending on the borrowing term. The CLP will remove this interest rate advantage, but it will also eliminate the interest rate risk that units are currently bearing. The University believes it is more appropriate for interest rate risk to be borne centrally, rather than with units that could place the individual school's financial status at risk.

Procedural Considerations

Units should initiate the process of CLP loan review in parallel with the project approval process with the Office of the Vice President for Capital Planning and Facilities. Since all financed projects (with the exception of student fee replacement projects) will go through CLP as part of its funding, CLP approval should be obtained prior to seeking formal project approval from the Board of Trustees.

The State project approval process should be largely unaffected (Governor letter, State Budget Agency, and Indiana Commission for Higher Education approvals should remain the same). The Office of the Treasurer will communicate with the Indiana Finance Authority and the State Budget Agency on a regular basis and will maintain a list of projects (to be approved by the State Budget Agency) for which CP can be issued. The State Budget Agency will also have to approve the initial issuance of CP and the maximum amount that can be outstanding. The Board of Trustees and the Finance, Audit, and Strategic Planning Committee will also need to approve the CP program.

Internal loans outstanding prior to the creation of the CLP will be grandfathered and will remain outstanding with the same terms and conditions. Units will have the option to refinance their outstanding loans under the new CLP terms, but this will not be mandatory.

CLP Operation and Oversight

The Office of the Treasurer will have day-to-day operational responsibility for the CLP. The Fiscal Officer or Account Manager on CLP accounts will produce separate financial statements to report of the overall financial condition of the CLP on an annual basis to the Treasurer.

Proposed Timeline

In order to facilitate execution of fiscal year 2016 projects and financings under this proposed structure, the following timeline is proposed:

- August/September: Communication of CLP with senior leadership, departments, and campuses
- October: Introduction to Board of Trustees and discussion
- December: Revisions to Internal Loan and Capital Financing Policies
- February 2016: Official creation of CLP
- March 2016 or after: Initial loan approvals and external debt issuance under CLP methodology

Interest Rate Comparison (Exhibit B) -

University	**Rate-10 years and Under**	**Rate Over 10 Years (if different)**
Cornell University	6.00%	
Harvard University	5.00%	
University of Virginia	4.75%	
University of Washington^^	4.75%	
Ohio State University**	4.50%	4.75%
University of Pennsylvania	4.50%	
Emory University	4.25%	
Stanford University	4.25%	
Indiana University (preliminary)^^	**4.25%**	**4.75%**
Columbia University	4.750%	
University of Texas^^	4.50%	

**Ohio State has a 4.00% rate for loans less than 5 years in term.

^^Also carry short term interim financing option based on commercial paper rate or similar.