

UNIVERSITY OF PUGET SOUND
DEBT POLICY

Last Revised May 12, 2006

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INTRODUCTION AND PURPOSE

This Debt Policy Statement serves to articulate Puget Sound's philosophy regarding debt and to establish a framework to help guide decisions regarding the use and management of debt. As the university establishes institutional priorities through its strategic planning processes, including its campus master planning, the university will consider utilizing a mix of financing and funding sources including gifts, internal reserves and investments, and external debt. Appropriate use of leverage will enable the university to advance its mission, achieve its strategic goals, and ensure financial health in present terms and over the long term. This policy will help ensure that an appropriate mix of funding sources are utilized, that Puget Sound's debt capacity is allocated strategically, and that Puget Sound's debt levels and types of debt are appropriate and responsible given the university's financial strength and risk tolerance levels.

This policy shall be effective until the Board of Trustees approves modifications. It is anticipated that the Finance and Facilities Committee will review this policy on an ongoing basis at least annually to ensure that it remains responsive to evolving priorities, strategic initiatives, and the external environment. The Finance and Facilities Committee will recommend modifications as needed to the Board of Trustees.

Appendix A contains a glossary of terms used in this policy statement.

SCOPE

For purposes of this policy statement, debt is defined to include all short- and long-term obligations, guarantees, and instruments that have the effect of committing the university to future payments and therefore impacting its credit. In addition to bonds, notes, and leases, debt includes other obligations that utilize the university's debt capacity, even if the transactions are not included in the university's financial statements or disclosed in the notes thereto.

OBJECTIVES

The broad objectives for this debt policy are to:

1. Strategically use the university's credit to fund mission critical projects,
2. Manage the university's credit to maintain the highest acceptable credit rating that will permit the university to continue to issue debt at favorable rates,
and
3. Optimize the debt portfolio as a whole, while also optimizing transactional and project-specific debt.

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GENERAL FRAMEWORK FOR DEBT UTILIZATION AND MANAGEMENT

Consideration is given to purpose, affordability, risk management, and financial structure (balance sheet) management in developing a framework for debt utilization and management:

1. Purpose includes ensuring that the debt-funded project will help the university further its mission or reach its goals.
2. Affordability includes an analysis of the cost of capital, cash flow forecasts, and rationale to instill budget discipline and ensure intergenerational equity between the beneficiaries and payers of debt.
3. Risk management includes an appropriate weighting of fixed and variable rate debt, a plan to manage liquidity risks and exposures, and rationale for matching assets to liabilities along the duration spectrum.
4. Financial structure (balance sheet) management includes a goal for establishing and maintaining the highest acceptable credit rating, a rationale for the appropriate level of debt versus equity, and proactive monitoring of capital markets to manage debt.

PRINCIPLES OF DEBT UTILIZATION AND MANAGEMENT

1. Only projects that further the mission and strategic goals of the university, either directly or indirectly, will be considered for debt financing.
2. To the extent possible, gifts, grants, and internal reserves will be used to fund capital projects. Debt represents a valuable and scarce resource and will be used conservatively and strategically.
3. Bond financing will be coordinated to the extent possible so that multiple projects can be accommodated in a single borrowing to reduce overall issuance costs per dollar of debt issued. Bridge financing from external or internal sources may be used for low-cost interim financing to facilitate best timing considering project schedules, fundraising schedules, bond financing schedules, and other variables.
4. The university will consider all methods of bond sales, including negotiated, competitive, private placement and auction.
5. The university will limit its overall debt to a level that, when viewed in the context of its current and future strategic objectives, is intended to optimize creditworthiness over the long term. In considering debt capacity and affordability, the university will compare its financial ratios, including those described in Appendix B, to other rated

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institutions and to its peer group. The university will also prepare long-term cash flow projections to demonstrate affordability within its budget or dedicated reserves. Decisions will be made based on the specific and unique needs of the university consistent with this debt policy.

6. The use of debt must be supported by an achievable financial plan that includes servicing the debt and meeting any new or increased operating costs associated with the project, including long-term maintenance costs. A project that generates a new revenue stream or can create budgetary savings will receive priority consideration.
7. The university will seek the overall lowest cost source of financing when issuing debt, considered concurrently with the associated risks. It will consider the costs and benefits associated with different types of financing and liquidity options, including, for example, credit enhancement via letter of credit or bond insurance and liquidity enhancement via internal or external liquidity support.
8. The university recognizes the desirability of having exposure to variable-rate debt as a component of its debt portfolio in order to:
 - a. take advantage of prepayment and restructuring flexibility,
 - b. benefit from historically lower average variable rate interest costs,
 - c. provide a “match” (or natural hedge) to the university’s short-term liquid investment balances
 - d. enhance the ability to undertake optimal financial structure management
 - e. enhance the ability to undertake risk management strategies, and
 - f. potentially provide an economically more attractive funding alternative than cash.

The portfolio allocation to variable rate debt will be analyzed on an after-derivative basis, will have an appropriate relationship to short-term liquid assets, and will take into consideration rating and other implications. The allocation of variable rate debt may be managed or adjusted through the issuance of new debt or refunding of outstanding debt and through the use of interest rate swaps and other derivative products such as caps and collars. Derivative products, including swaps will not be used for speculation. For policy purposes, speculation means taking additional risks, unrelated to the university’s business, in an effort to increase returns.

The university will analyze the costs and benefits of any derivative instrument relative to achieving its long-term capital structure objectives and will include consideration of incorporating risk mitigation features. Under no circumstances will a derivative transaction be utilized that is not understood fully by management or that imposes inappropriate risk to the university. The risks to be considered include, but are not limited to, tax risk, interest rate risk, liquidity risk, counterparty risk, basis

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risk, and any other potential risk factors that are relevant to the university. The university will seek to diversify counterparty risk and will execute credit-sensitive derivative transactions only with counterparties with strong credit ratings. While the university may have a flexible credit standard, it will attempt to do business with counterparties rated in the “AA” category or above as of the transaction date. The university will structure swap and other derivative agreements to limit losses due to non-performance of its swap counterparties.

9. The university will employ maturity structures that correspond with the expected useful life of the projects to be financed. Should debt be issued with a bullet or balloon principal payment at the final maturity, optional principal payments will typically be made over the term of the debt to result in generally level annual debt (principal and interest) payments. Call features will be structured to provide the highest degree of flexibility relative to cost and consistent with market requirements.
10. Annual debt interest and principal amortization payments will be provided for in the annual operating budget or in specific designated or restricted funds. Variable-rate interest will be budgeted conservatively at fixed rate levels in effect at the time the variable rate bonds were originally issued until an interest-rate fluctuation reserve recommended by the Vice President for Finance and Administration and approved by the Finance and Facilities Committee has been accumulated. Subsequently, variable-rate interest shall then be budgeted at conservative rate levels based on historic norms.
11. Debt may be secured or unsecured. Unsecured debt and debt backed by pledged revenues are preferred to the extent it is cost effective. A “negative pledge” is preferred over secured borrowings. For secured borrowings, only campus facilities financed by the debt or unrestricted quasi-endowment investments may be pledged as collateral. The university will seek to avoid or minimize operating or financial covenants and coverage levels consistent with credit rating and market requirements.
12. The university will interact with credit rating agencies and will strive to maintain the highest acceptable credit rating. The credit rating process is described in Appendix C of this policy statement.
13. The university will monitor refunding opportunities of outstanding debt and will consider undertaking current or advance refunding outstanding debt when the net present value savings are positive and the refunding will support the strategic goals of the university.
14. The university will invest bond proceeds appropriately to achieve the highest return available under arbitrage limitations consistent with preservation of principal. The university will comply with arbitrage requirements on any invested bond funds.

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ASSIGNMENT OF RESPONSIBILITIES

Board of Trustees

The Board of Trustees is responsible for establishing and approving modifications to this Debt Policy Statement as recommended by the Finance and Facilities Committee.

The Board of Trustees has ultimate decision making authority and responsibility for the assumption of debt, both direct and indirect. The Board of Trustees is responsible for authorizing the issuance of debt, for modifying the nature of or accelerating the repayment of existing debt, and for approving any debt-related derivative contracts.

The Board of Trustees may choose to delegate to an ad hoc committee of the Board the authority to approve terms or take actions necessary to complete the issuance or modification of debt. The Board of Trustees may delegate to the Vice President for Finance and Administration, the Associate Vice President for Accounting and Budget Services, or the Associate Vice President for Treasury, the authority to take such actions and to negotiate, review, and approve such agreements as necessary to accomplish the issuance or management of debt as authorized by the Board and/or its ad hoc committee.

The Board of Trustees delegates to management the approval of debt resulting from normal operations within approved budgets, such as trade payables, equipment leases, and other accrued liabilities. The Board of Trustees delegates to management the negotiation and approval of an unsecured line of credit not to exceed \$5 million. The board also delegates to management the negotiation and approval of financing agreements to acquire property in high priority zones consistent with the campus master plan, providing such financing does not exceed \$2 million in the aggregate and the university has identified an appropriate funding source for the related debt service payments.

Finance and Facilities Committee of the Board of Trustees

The Finance and Facilities Committee is responsible for reviewing this Debt Policy Statement at least annually and recommending modifications as needed to the Board of Trustees.

The Finance and Facilities Committee is responsible for recommending to the Board of Trustees the issuance of new debt, the modification or repayment acceleration of existing debt, and the approval of any debt-related derivative contracts. The Finance and Facilities Committee will consider and act upon recommendations from the President and Vice President for Finance and Administration.

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President

The President will be supported by the Vice President for Finance and Administration in the development of recommendations to the Board regarding the use of debt.

Vice President for Finance and Administration and Staff

The Vice President for Finance and Administration, in consultation with the President, is responsible for ongoing debt management, including monitoring the debt markets and recommending appropriate tactical strategies given the interest rate environment, the university's liquidity position, tax regulations, and market dynamics. The Vice President for Finance and Administration will seek appropriate counsel from experts. The Vice President for Finance and Administration will develop and manage relationships with credit agencies, investment bankers, financial advisors, Washington Higher Education Facilities Authority, financial institutions, and others in support of the objectives stated in this policy. The Vice President for Finance and Administration is responsible for ensuring timely payment of debt service payments, monitoring debt covenant compliance, debt related financial reporting, and regulatory compliance.

The Vice President for Finance and Administration is responsible for reviewing and approving equipment leases and other financing arrangements in support of normal operations funded by approved budgets. The Vice President for Finance and Administration is responsible for negotiating and approving an unsecured line of credit not to exceed \$5 million.

The Vice President for Finance and Administration, in consultation with the President, is responsible for negotiating and approving financing agreements to acquire or develop property in support of the campus master plan or that is otherwise in the strategic interest of the university, providing such financing does not exceed \$2 million in the aggregate and there is an available funding source for the related debt service.

The Vice President for Finance and Administration may delegate the above responsibilities to senior staff reporting directly to her/him and will work closely with those senior staff on such matters.

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Appendix A: GLOSSARY OF TERMS

<i>Basis Risk</i>	The risk that the price of a derivative instrument will vary from that of the underlying commodity.
<i>BMA</i>	The Bond Market Association (BMA) Index is calculated by taking the weighted-average of the clearing rates for a pool of high-grade tax-exempt short-term issues with weekly resets. The BMA Index is a widely used proxy for high-grade weekly bonds.
<i>Campus facilities</i>	Fixed assets including land, buildings, leasehold improvements, furniture, equipment, and collections. Also referred to as “plant.”
<i>Campus facilities, net</i>	Total campus facilities less accumulated depreciation. Also referred to as “net campus facilities.”
<i>Counterparty risk</i>	The risk that a counterparty to a contract defaults and does not fulfill its obligations.
<i>Credit</i>	Credit is the ability to repay a financial obligation.
<i>Credit rating</i>	A measure of the quality and safety of a bond the university has issued, based on the university’s financial condition. More specifically, an evaluation from a rating agency indicating the relative likelihood that the university will be able to meet scheduled interest and principal repayments to bondholders.
<i>Debt</i>	All short- and long-term obligations, guarantees, and instruments that have the effect of committing the university to future payments and therefore impacting its credit.
<i>Debt capacity</i>	The amount of debt the university can take on under specified criteria. Internal criteria include financial ratios. External criteria include credit ratings from rating agencies.
<i>Derivative</i>	A financial tool that derives its value from another more fundamental financial instrument, such as a commitment to buy a bond for a certain sum on a certain date, or a hedge against a change in interest rates. The purpose of derivatives is to reduce risk and/or reduce cost.
<i>Direct debt</i>	The amount of long-term debt recognized in the university’s audited statement of financial position (balance sheet).
<i>Financial ratios</i>	One value divided by another, which are used to study and interpret relationships between financial variables.

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<i>Interest rate cap</i>	An options contract which puts an upper limit on a variable interest rate. The writer of the cap has to pay the holder of the cap the difference between the variable rate and the reference rate when that reference rate is breached. There is a premium to be paid by the buyer of such a contract in order to gain the certainty of a maximum payout.
<i>Interest rate collar</i>	A security which combines the purchase of a cap and the sale of a floor to specify a range in which an interest rate will fluctuate. The security insulates the buyer against the risk of a significant rise in a floating rate, but limits the benefits of a drop in that floating rate.
<i>Interest rate risk</i>	The risk that short-term interest rates will increase beyond the university's debt service provisions, thereby taking resources away from other competing programs or uses.
<i>Interest rate swap</i>	An exchange of interest payments on a specific principal amount. This is a counterparty agreement, and so can be standardized to the requirements of the parties involved. An interest rate swap usually involves just two parties, but occasionally involves more. Often, an interest rate swap involves exchanging a fixed amount per payment period for a payment that is not fixed (the floating side of the swap would usually be linked to another interest rate, such as LIBOR or BMA). In an interest rate swap, the principal amount is never exchanged, it is just a notional principal amount. Also, on a payment date, it is normally the case that only the difference between the two payment amounts is turned over to the party that is entitled to it, as opposed to exchanging the full interest amounts. Thus, an interest rate swap usually involves very little cash outlay.
<i>Leverage</i>	The degree to which the university is utilizing borrowed money versus revenues or net assets to finance projects.
<i>LIBOR</i>	London Inter-Bank Offer Rate. Interest rate that banks charge each other for loans (usually in Eurodollars). This rate is applicable to the short-term international inter-bank market, and applies to very large loans borrowed for anywhere from one day to five years. This market allows banks with liquidity requirements to borrow quickly from other banks with surpluses, enabling banks to avoid holding excessively large amounts of their asset base as liquid assets. The LIBOR is officially fixed by a small group of large London banks each day at 11:00 a.m. GMT, for periods of from one day to up to 12 months.

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<i>Liquidity or funding risk</i>	The possibility that buyers in the market would not be willing to buy the bonds being sold by current investors during the regular remarketing schedule and as a result the university would have to purchase those bonds when presented for sale on the market.
<i>Net investment in campus facilities</i>	Net campus facilities less direct debt. Also referred to as net investment in plant.
<i>Quasi-endowment</i>	Funds that have been established by the Board of Trustees to function like an endowment, but that may be expended at the discretion of the Board.
<i>Rating agencies</i>	Companies that publish borrowers' credit ratings, including Moody's Investors Service and Standard and Poor's.
<i>Swap</i>	A type of derivative product whereby two parties enter into a transaction under which they exchange streams of payments over time according to specified terms. The most common type is an interest rate swap, in which one party agrees to exchange a fixed interest rate for an adjustable rate (or vice-versa) with another party.
<i>Tax risk</i>	The risk that the premium received from being a tax-exempt interest organization would be altered in some way by Federal tax cuts or changes in the basic tax structure.

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Appendix B: DEBT CAPACITY REVIEW

The following ratios and weightings will be used as a guide when determining debt capacity.

Financial Ratio	Definition / Formula for Calculation	Weighting
Unrestricted Resources to Debt	$\frac{\text{Unrestricted Net Assets} - \text{Net Investment in Campus Facilities}}{\text{Direct Debt}}$	45%
Expendable Resources to Debt	$\frac{\text{Unrestricted and Temporarily Restricted Net Assets} - \text{Net Investment in Campus Facilities}}{\text{Direct Debt}}$	10%
Total Resources to Debt	$\frac{\text{Total Net Assets} - \text{Net Investment in Campus Facilities}}{\text{Direct Debt}}$	5%
Debt Service to Operations	$\frac{\text{Actual Annual Debt Service}}{\text{Total Operating Expenses}}$	10%
Maximum Annual Debt Service (MADS) Coverage	$\frac{\text{Unrestricted Operating Revenues} - \text{Unrestricted Operating Expenses} + \text{Interest Expense and Depreciation}}{\text{Maximum Annual Principal and Interest Payments}}$	30%

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Appendix C: CREDIT RATINGS AND THE CREDIT RATING PROCESS

Credit Rating

A credit rating is an independent assessment of the creditworthiness of a bank (note or any security of indebtedness) by a credit rating agency. It measures the probability of the timely repayment of the principal and interest of a bond. Generally, a higher credit rating would lead to a more favorable effect on the marketability of a bond. The long-term credit rating symbols are generally assigned with “triple A” as the highest and “triple B” (or Baa) as the lowest in investment grade. Anything below triple B is commonly known as a “junk bond.”

Rating Definitions – Investment Grades

AAA (Aaa)

Bonds rated AAA have the highest ratings assigned by rating agencies. They carry the smallest degree of investment risk. Issuer’s capacity to pay interest and principal is extremely strong.

AA (Aa)

Bonds rated AA are judged to be of high quality by all standards. They differ from the highest rating (AAA) bonds only in a small degree. Issuer’s capacity to pay interest and principal is very strong.

A

Bonds rated A have strong capacity to pay interest and repay principal although they are somewhat more susceptible to the adverse affects of changes in circumstances and economic conditions than bonds in higher rated categories.

BBB (Baa)

Bonds rated BBB are considered medium grade obligations. They are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or unreliable over any length of time. These bonds lack outstanding important characteristics and have speculative characteristics as well.

+ / - / 1, 2, 3

Relative standing within a rating category

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Credit Rating Agencies

Currently, Moody's Investors Service (Moody's) and Standard & Poor's Ratings Services (S&P) rate the university's general obligation bonds. Other credit rating agencies include A.M. Best Company, Inc., Dominion Bond Rating Service Ltd., and Fitch, Inc.

Determinants of a Credit Rating

In determining the credit rating it assigns, the rating agency evaluates components of the institution's operational and programmatic characteristics.



Credit Rating Process

The institution, with assistance from the bond underwriter, creates a comprehensive credit rating package and distributes it to one or more credit rating agencies. The credit information package highlights the strengths and unique features of the institution and provides details on necessary credit factors such as demand characteristics, financial position, senior management, and debt. For a first-time rating, an initial rating meeting is generally held on the institution's campus. The discussion at the rating meeting generally focuses on the following subjects:

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- Background and history of the institution
- Industry/sector trends
- National political and regulatory environment
- Management quality, experience, track record, and attitude toward risk-taking
- Management structure
- Basic operating and competitive position
- Organizational strategy and philosophy
- Debt structure, including structural subordination and priority of claim, and
- Financial position and sources of liquidity, including (1) cash flow stability and predictability and ability to service debt obligations, (2) operating margin, and (3) a balance sheet analysis in terms of debt profile and maturity.

A rating agency visit to the borrower's campus to view campus facilities and meet senior management also highlights an institution's strengths and may be a determining factor in achieving the highest possible credit rating.

Upon completion of the analysis, the analyst will make a recommendation to a rating committee comprised of credit rating agency personnel. A credit rating is forward-looking, and, by its very nature, subjective. The role of the rating committee is to introduce as much objectivity into the process as possible by bringing an understanding of the relevant risk factors and viewpoints to each and every analysis. A common set of basic analytical principles, including global consistency, an emphasis on qualitative factors, and a focus on the long-term guides the rating process. In determining the credit rating it assigns, the rating agency evaluates components of the institution's operational and programmatic characteristics. Once the rating committee has made its decision, the institution is informed of the rating and the rationale used by the credit rating agency.