VIII—12.00 – Policy on Debt Management

(Approved by the Board of Regents April 7, 1995; Revised April 20, 2018)

I. Purpose

The purpose of this debt management policy is to establish for the University System of Maryland, including all of its constituent institutions (collectively the "USM") a comprehensive and prudent debt management program that is responsive to the needs of the USM and its constituent institutions, yet allows efficient access to capital markets by:

- Managing USM's overall debt level in order to maintain a minimum underlying credit rating in the "AA+" or equivalent category from all three rating agencies (Moody's, Fitch, S & P)

- Limiting risk within USM's debt portfolio by effectively balancing the goal of lowest cost of capital with the goal of managing interest rate risk.

- Managing outstanding debt in such a manner to take advantage of interest rate cycles and refunding opportunities.

II. Debt Caps

A. Direct and Indirect debt will be managed with the objective of maintaining a rating in the "AA+" or equivalent category from the three major rating agencies (Moody's, Fitch, and S&P).

B. Debt service associated with USM direct debt may not exceed 4.0% of USM operating revenues plus State Appropriations as defined by Generally Accepted Accounting Principles (GAAP), calculated using the most recent audited financial statements, using principal and interest payments reported on the Statement of Cash Flows, adjusted for any principal paid associated with refinanced debt, and divided into total operating revenues plus state appropriations.

C. Available Resources must be at least 90% of direct debt, calculated using the most recent audited financial statements, adjusted for spending and debt commitments not yet reflected in the financial statements. The interaction of the debt service limit in paragraph B. above, and the Available Resources to direct debt minimum is expected to maintain the System's financial strength and operating flexibility at a level comparable to other institutions with the same rating by the three major rating agencies.

D. USM Indirect Debt may not exceed 50% of USM Direct Debt.

E. Outstanding debt may not exceed the limits established in Section 19-102 of the Education Article of the Annotated Code of Maryland.

F. The Vice Chancellor for Administration and Finance (VCAF) will review the debt ratios and comparison with similar metrics reported by other public higher education institutions in the same bond rating category, annually. In the event of unusual financial circumstances, the VCAF may recommend to the Board of Regents a one-year waiver to the debt limitations. The Vice Chancellor for Administration and Finance will display the status of actual USM financial metrics relative to the limits and standards of this Board of Regents policy, as well as a comparison of similar ratios based on publicly available financial statements for other public higher education institutions, on its website.

G. The Board of Regents will take these debt limitations into consideration when approving any initiative that has any impact on USM debt capacity.

III. Debt Management Strategies

A. *Fixed versus variable rate allocation* – Variable rate debt sometimes offers a lower cost of capital, but introduces additional risks. To limit this risk, variable rate debt will be no more than 50% of the overall USM debt outstanding. Variable rate exposure includes exposure achieved directly through variable rate debt issuance and indirectly by entering into an interest rate swap agreement.

B. *Refunding Targets* – The USM and its financial advisor will continually monitor and periodically review the USM's outstanding debt portfolio for refunding and/or restructuring opportunities. In general, the USM will consider refinancing (within Federal tax constraints) when a current or advanced refunding of debt provides a net present value debt service savings of at least 3% of the refunded par amount of the bonds. Refinancing or restructuring opportunities that provide savings of less than 3%, or with negative savings, may be considered if there is a compelling policy objective such as restructuring of principal, or changing financial or legal covenants that are disadvantageous to USM.

C. *Interest Rate Swaps and Derivatives* – In general, swaps are utilized to reduce the cost and/or risk of existing or planned USM variable rate debt. By using swaps in a prudent manner, the USM can take advantage of market opportunities to reduce debt service cost and/or interest rate risk. Before entering into any interest rate swap agreement, the USM, shall conduct a review to include each of the following, as appropriate:

1. Identification of the proposed benefit and potential interest rate swap risks, which shall include, but not necessarily be limited to, those risks outlined herein.

2. Independent analysis of potential savings from a proposed transaction.

3. Comparison of fixed versus variable rate options and interest rate swap exposure before and after the proposed transaction.

4. Market Net Termination Exposure (as outlined herein) of the USM for all existing and proposed transactions.

5. The USM will consider, to the extent it deems relevant, any rating reports or criteria regarding interest rate swaps by rating agencies.

6. In reviewing proposed or possible interest rate swaps or options, USM shall consider each of the following types of risks, as applicable: Counterparty Risk, Termination Risk, Tax Risk, Basis Risk, Tax Exemption Risk, as defined in Appendix A.

IV. Process

A. The VCAF, or designee, shall assess the impact of the following types of proposed transactions on debt capacity:

   1. Leases in which the System or an institution is the lessee, with respect to a single facility, multiple facilities, or other asset in which the cumulative (i) consideration is expected to exceed $500,000 in any year; (ii) aggregate rent exceeds $2 million, or (iii) the initial lease term exceeds ten years. The USM will consider the dollar amount of the lease, the percent of the building being leased, the lease term, and any financial obligations or risks assumed by the tenant.

   2. Ground Leases.

   3. Public Private Partnerships

   4. Lease/leaseback and sale/leaseback arrangements.

   5. Bondable or Credit Lease Structure

   6. Indirect Subsidies of Third-Party Debt

   7. Any other financial relationship not identified above between the USM and/or its constituent institutions and an external entity involving facilities or property.

B. The use of a non-appropriation clause does not change the characterization of the commitment or obligation for debt capacity purposes.

C. The USM Office of Administration and Finance and the Office of the Attorney General are to be involved in any financing transaction as early as reasonably possible but must be fully briefed and involved before any legal or verbal commitment is made by an institution and before any letter of intent, memorandum of understanding or legal documents are prepared.

D. The Board of Regents approves each project to be financed using the proceeds of USM Revenue Bonds through a bond resolution. Authority to spend and/or the authority to issue debt for a specific project will expire five years after the date of the authorizing resolution. Authority to spend may be extended by the VCAF under special circumstances.

V. **Financing Commitments** (Replacement for Board of Regents Policy VIII—8.00 – Policy on Financing Commitments).

A. Financing commitments of $5 million or more and financing commitments which require specific approval of the Board of Regents as a condition of the financing shall be approved by the Board.

B. The Board delegates to the Chancellor the authority to approve all financing commitments which do not require Board approval.

C. Except as provided in paragraph 4, the Chancellor may delegate to the Presidents the authority to approve financings of less than $50,000.

D. Any financing commitments involving pledges of tuition, auxiliary enterprise revenues, or student fees require approval of the Chancellor, or designee.

E. Refinancing transactions shall be subject to the provisions of this policy.

Appendix A

Definitions

A. Available Resources – Unrestricted Net Assets of the USM + Unrestricted Net Assets of the USM Affiliated Foundations + Accrued Vacation Liabilities as defined by Generally Accepted Accounting Principles (GAAP).

B. Direct Debt – A financing involving a legal commitment or guarantee by the USM to providers of capital, or a legal commitment or guarantee by the USM to a third party to obtain financing for a project. These financings would include, but are not limited to: USM revenue bonds; USM Revolving Equipment Loan Program; installment sale arrangements; equipment lease/purchase programs; certificates of participation; leases as reported on the Balance Sheet as liabilities; sale/lease back structures, and Indirect Subsidies of Third-Party Debt.

C. Indirect Debt – Any commitment to make payments, or any contingent future risk that the debt of others may be assumed by the USM that is not characterized as Direct Debt. Additionally, a financing in which the USM makes no legal commitments or guarantees, but retains some financial stake in the facility and/or the project is of some strategic value to the USM. Examples include, but are not limited to, public/private partnerships for student housing.

D. Indirect Subsidies of Third Party Debt – These are transactions in which the USM has agreed (whether or not subject to appropriation and whether or not guarantees or indemnity is provided from others) either to pay or be responsible for any costs to construct or operate a facility, or to divert or permit others to have rights in, the revenues from a project which would otherwise have been payable to the USM.

E. Interest Rate Swap – A contract between two parties (referred to as "counterparties") to exchange interest rate payments at specified dates in the future. The interest rate payments for a given counterparty equal the product of an interest rate (swap rate) and a principal amount. Usually, the swap rate for one counterparty is a fixed rate, while the swap rate for the other counterparty is a variable rate, although an Interest Rate Swap can also involve two variable rates (know as a "basis swap". The principal amount by which the swap rates are multiplied is generally referred to as the "notional." amount. That is, principal payments are not swapped, paid or exchanged. The notional principal amount is only an arithmetic device to calculate swap payments.

F. Interest Rate Swap Risks – One or more of the following risks may be associated with an Interest Rate Swap, depending on the floating index used in the transaction:

1. Counterparty Risk – The risk of a payment default on a swap by the other Counterparty.
2. Termination Risk – (a) The risk that a swap has a negative value and the issuer owes a "settlement or termination" fee if the contract is terminated due to either the occurrence of a termination event or a decision to voluntarily terminate the swap; and or (b) the loss of the hedge resulting from the involuntary termination.
3. Tax Risk – A mismatch between changes in the rate or price on an issuer's underlying bonds and the swap caused by a reduction or elimination of the benefits of the tax exemption for interest on state and local government bonds (e.g., a tax cut) that results in an increase in the ratio of tax-exempt to taxable yields, which is not matched by the swap index.
4. Basis Risk – A mismatch between the rate on an issuer's underlying bonds and the rate paid under the swap; e.g., a tax-exempt variable rate issue which trades at percentage of BMA while the issuer receives payment based on a percentage of LIBOR under the swap; this risk can be exacerbated by a drop in income tax rates because the BMA Index is then closer to LIBOR and the counterparty is paying a fixed percentage of LIBOR.
5. Tax Exemption Risk – The risk that the transaction may make the issuer's related bonds taxable.

G. Variable Rate Debt – A bond that bears interest at a variable or floating rate established at specified intervals (e.g., flexible, auction, daily, weekly, monthly, or annually).