

DEBT POLICY

POLICY NUMBER: RESERVED FOR FUTURE USE

POLICY TYPE: ADMINISTRATIVE

RESPONSIBLE OFFICIAL TITLE: CHIEF FINANCIAL OFFICER

RESPONSIBLE OFFICE: COMPTROLLER

EFFECTIVE DATE: 8/11/2012

NEXT REVIEW DATE: 8/11/2016

I. POLICY STATEMENT

In support of its mission, the University must make ongoing strategic capital investments in facilities and equipment. University debt provides a critical funding source for capital investments, in addition to state bonds and capital appropriations, internal reserves and investments, private gifts and other sources.

This policy provides a framework to be used by administration to ensure that an appropriate mix of funding sources are utilized, that the University's debt capacity (both external and internal) is allocated strategically, and the University's debt levels and types of debt are appropriate and responsible, given the University's financial strength and risk tolerance levels. The University's debt capacity is a limited resource that should be utilized for projects that support the core mission and strategic plan of the University. The amount of debt incurred has an impact on the financial health of the University and its credit rating and associated cost of borrowing.

Objectives

The objectives stated below provide the structure for decisions regarding the use and management of external debt and internal borrowing from the University's net assets. The Debt Policy and objectives are subject to reevaluation and change over time.

The debt policy ...

1. Establishes a formal link between the University's strategic planning process, including the development of the associated Six-year capital plan, and the debt issuance approval process to ensure that the University's debt capacity is allocated consistent with the University's Strategic Plan. It outlines a process for identifying and prioritizing capital projects considered eligible for debt financing.
2. Manages the University's credit rating to meet its strategic objectives while maintaining the highest acceptable credit worthiness and most favorable relative cost of capital and borrowing terms. It limits external and internal debt levels to maintain sufficient liquidity to support operations and future capital projects and strategic initiatives. This Policy does not attempt to define specific rating that the University must maintain.
3. Defines quantitative tests that will be used to evaluate the University's overall financial health, liquidity and present and future debt capacity.
4. Defines project-specific quantitative tests, as appropriate, which will be used to determine the financial feasibility of an individual project.
5. Establishes guidelines to limit the risk of the total external debt portfolio. The University will manage debt on a portfolio basis, rather than on a transactional or project specific basis, and will use an appropriate mix of fixed and variable rate debt (as permitted by the Commonwealth of Kentucky) to

achieve the lowest cost of capital while limiting exposure to market interest rate shifts. Coordinates debt management decisions with asset management decisions to optimize overall funding and portfolio management strategies.

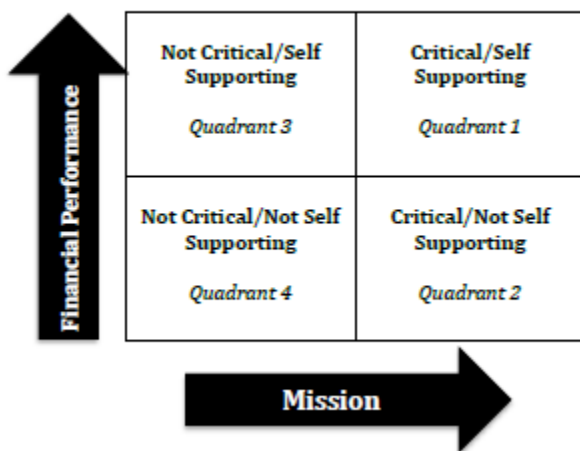
6. Establishes guidelines to manage variable rate interest exposure for external debt.
7. Summarizes a framework for internal loans including:
 - a. maximum outstanding internal loan balance
 - b. duration
 - c. interest rates
8. Assigns responsibilities for the implementation and management of the Debt Policy.

Identifying and Prioritizing Capital Projects

Recognizing that financial resources are not sufficient to fund all capital projects, management must allocate debt strategically, continuing to explore alternate sources of funding for projects. External support, philanthropy, and direct Commonwealth investment remain critical to the University’s facilities investment plan. Each capital project is analyzed at its inception to ensure that capital issued in the most effective manner and in the best interests of the University. There is an initial institutional review of each project, prior to its inclusion in the University’s Six-year Capital Plan.

The University uses the debt allocation matrix below to assist in prioritizing capital projects requiring debt.

FIGURE 1. DEBT ALLOCATION MATRIX



Explanation of debt allocation matrix

Quadrant 1: Project **is critical** to the core mission/strategic plan of the University **and** has its own funding source (i.e., non-general fund supported).

Quadrant 2: Project **is critical** to the core mission/strategic plan of the University **but does not** have its own funding source (i.e., will require general fund support).

Quadrant 3: Project **is not critical** to the core mission/strategic plan of the University **but** has its own funding source (i.e., non-general fund supported).

Quadrant 4: Project **is not critical** to the core mission/strategic plan of the University **and does not** have its own funding source (i.e., will require general fund support).

Note that approval of projects in Quadrants 3 and 4 will reduce the ability to issue debt for the mission critical projects identified in Quadrants 1 and 2.

Guidelines for Prioritizing Projects

The following guidelines will be used to prioritize capital projects and make decisions about financing options and use of debt:

1. Only projects related to the core mission and/or the strategic plan of the University will be eligible for debt financing.
2. In assessing the possible use of debt, all financing and revenue sources will be considered such as state bonds, University bonds, project-generating revenues, expendable reserves, capital leases and internal loans from the University's net assets. Internal and external debt is to be used conservatively and strategically.
3. Every project considered for financing must be approved by the appropriate Vice President and have a detailed construction plan, documented cost estimates, projected incremental operating costs, estimated debt service and other information relevant to the financing decision. As part of this initial institutional review, the University also will assess, based on the project's business plan, the sufficiency of project revenues to support any internal loans. Projects with a defined revenue stream, or documented estimated cost savings, will typically be given a higher priority.

External Financing

Bank qualified financing

In instances when the University expects small debt issues, the University may utilize bank qualified debt to take advantage of lower interest rates. The use of bank qualified debt limits debt issues of the University to \$10 million throughout the calendar year.

Bond anticipation notes

The University may choose to utilize bond anticipation notes as a temporary funding source prior to and in anticipation of the completion of a bond sale. Bond anticipation notes will be retired using the bond proceeds.

Mix of fixed and variable debt

Due to the financing flexibility and lower interest cost typically associated with variable rate debt, it may be desirable, depending on market conditions, to maintain a portion of the University's aggregate debt on a floating (variable) rate basis. However, variable rate debt also introduces volatility to the debt service obligations. Therefore, the University will balance the mix of variable and fixed rate debt according to a maximum of 30% variable, with a target guideline of zero to 20% variable, although the actual percentage for debt outstanding will fluctuate from time to time, due in part to financing needs and prevailing market conditions.

Use of interest rate swap products

The use of interest rate swaps may be employed primarily to manage the University's variable rate exposure. The University will utilize a framework to evaluate potential instruments through evaluation of its variable rate allocation, market and interest rate conditions, and the compensation for undertaking counterparty exposure.

Credit Rating

The University will maintain ongoing communications with bond rating agencies to update the agencies about the financial and operating performance of the University in order to attain the highest credit rating possible.

Internal Loans and Cash Advances

Internal loans

Internal loans of the University's net assets can provide an alternate source of funding when external debt is not available or when there is a gap between the receipt of funds such as a gift or grant and the date of acquisition of construction of a project. The life of an internal loan is generally more than one year.

The following guidelines apply:

1. Internal loans cannot compromise the operational liquidity of the University. The University must maintain **at least 60 days** of operating cash at all times.
2. All requests for internal loans shall be submitted to the Debt Management Committee by the appropriate Vice President for review and recommendation to the President. Any internal loan great than **\$500,000** must be approved by the Board of Regents.
3. The aggregate outstanding internal loan balance will be continuously monitored by the Office of the Comptroller and **shall not exceed \$2 million**. An itemized record of outstanding internal loans and repayment schedules will be maintained by the Office of the Comptroller.
4. Endowment funds may not be loaned or considered in determining the number of days of operating cash available.
5. Prior to the transfer of internal loan funds, a memorandum of agreement shall be executed by the President. The agreement shall identify the funding source, formal repayment schedule, interest rate and specified term. The internal loan request must be approved by the Vice President for Administration and Finance and the Senior Director of the Budget Office.
6. **The maximum loan term is 75% of the estimated useful life of the asset or 20 years, whichever is less.**
7. Interest shall be charged based **on a three year treasury note plus 200 basis points (2.0%)**. The annual interest rate will be determined March 1, effective for the following fiscal year (July through June).

Cash advances

Under extenuating circumstances, the University may advance cash for a limited duration (not to exceed **90 days**) to self-supporting units. Such advances for working capital or to cash-flow capital projects must not compromise the University's operational liquidity and must be approved by the Vice President for Administration and Finance and the Senior Director of the Budget Office. Prior to a cash advance, a memorandum of agreement shall be executed by the President. The agreement shall identify the source of repayment, repayment schedule, interest rate and specified term. Cash advances will not be considered in determining the maximum internal loan capacity.

Any cash advance which exceeds 90 days will be re-classified as an internal loan and subject to the aforementioned guidelines.

The President, upon recommendation from the Debt Management Committee, may approve exceptions to the Internal Loans and Cash Advances guidelines.

Financial Ratios/Quantitative Tests

The University will establish guidelines for overall debt management using a select number of financial ratios, calculated and reported both annually and when new debt is issued. This set of financial ratios may be revised periodically to reflect changes in accounting standards. These ratios will serve as indicators of the University's financial health and capacity to incur new debt.

National rating agencies identify the University, the Research Foundation and the Foundation as a consolidated entity. Calculation of the core ratios and the ratings indicator ratios will follow the same methodology and will be based on the audited consolidated financial statements of both the University and the Foundation.

Ratios fall into three specific categories:

- a. Financial ratios that provide information about the overall financial health of the University
- b. Ratings indicator ratios that are specific to the ability to issue debt and are key elements used by rating agencies in rating the University's bonds
- c. Internal ratios that provide comparisons of the University to its peers.

See Appendix at the end of this section for the formulas for each of the key ratios.

1. Ratios That Provide Information About the University's Overall Financial Health

Four core financial ratios, when considered together and over time, will help to provide a high level assessment of the overall financial health of the University.

- a. **Primary Reserve Ratio.** Measures financial strength by comparing expendable net assets to total expenses. This ratio provides a snapshot of financial strength and flexibility by indicating how long the University could function using its expendable net assets, without relying on additional net assets generated by operations. A negative ratio or decreasing trend over time indicates expendable net assets are readily accessible to meet the operating and capital needs of the University.
- b. **Return on Net Assets Ratio.** Determines whether the University is financially better or worse than in previous years by measuring total economic return. **The threshold value is 4%.**
- c. **Net Operating Revenue Ratio.** Indicates whether total operating activities resulted in a surplus or deficit and measure the ability of the University to operate in the short term. **The optimal value for this ratio is 2%.**
- d. **Viability Ratio.** Measures the availability of expendable net assets to cover debt. As this ratio falls below 1:1, the University's ability to respond to adverse conditions, to attract capital from external sources and its flexibility to fund new objectives is diminished. This ratio is regarded as an important indicator of the ability to assume new debt. **The recommended value for this ratio is 1.25.**

Taken together, and in consideration of other indicators, the above core ratios represent the composite financial index which may be used to provide an overall financial measurement of the University.

2. Ratings Indicator Ratios

In addition to the four core financial ratios, there are many other ratios used by bond rating agencies in rating debt. These ratios, referred to as ratings indicator ratios, are specific to the ability to issue debt and are key determinants in the debt ratings assigned by the rating agencies. The following are considered among the important ratings indicator ratios:

- a. **Unrestricted Net Assets to Operating Expenses (times coverage) and Expendable Net Assets to Operating Expenses (times coverage).** These two balance sheet ratios provide indicator of near-to-medium term financial health by measuring the availability of unrestricted and expendable funds to cover debt should unexpected interruptions in cash flow occur. They provide an indicator of short term liquidity and/or financial flexibility in periods of volatility.
- b. **Unrestricted Net Assets to Debt (times coverage) and Expendable Net Assets to Debt (times coverage).** These two capital ratios measure the University's liquid assets to its debt.

- c. **Debt Service Coverage (times coverage).** Measures the ability to repay debt from current operating funds. This ratio measures whether sufficient operating cash flow is generated to issue and repay additional debt.

3. Internal Ratios

As part of the continuous monitoring of debt capacity, the following internal ratios have been developed to aid in assessing the University's financial standing and debt capacity.

- a. **Outstanding Debt per Student.** Measures the overall consolidated outstanding debt of the University and Foundation against the corresponding Fall full-time equivalent ("FTE") enrollment of the University. This calculation provides a measurement that is comparable across institutions and allows the University to compare its debt capacity against its peers, both nationally and across the Commonwealth of Kentucky.
- b. **Debt Service per Student.** Measures the overall consolidated debt service of the University and Foundation against the corresponding Fall FTE enrollment of the University. This calculation provides an additional measurement that is comparable across institutions and allows the University to compare its debt capacity against its peers, both nationally and across the Commonwealth of Kentucky.
- c. **Unrestricted Net Assets per Student.** Measures the University's most liquid financial resources against the corresponding Fall FTE enrollment of the University. This calculation is based strictly on the University and excludes all Foundation net assets. This calculation provides a basis to determine the University's ability to fund projects from net assets. This ratio offers a method to compare the University and its peers, both national and across the Commonwealth of Kentucky.

Project Specific Quantitative Tests

Consideration of the ratios calculated above will determine the ability and/or advisability of issuing debt from a University-wide perspective. Prioritization of individual projects to be allocated a portion of available debt capacity is a separate, internal decision that must be made before a project is initiated.

Many factors will influence this internal decision process. First, administration must determine how the project will be prioritized with regard to importance to the University's mission/strategic plan as described by the debt allocation matrix (four quadrant model) above. Additionally, every project considered for debt financing must have a management-approved plan of project costs, including incremental operating revenues and expenses.

Incremental revenues include revenue increases directly associated with the project (e.g., usage fees) that can only be realized if the project is undertaken. Similarly, incremental expenses include any increase in expected operating costs associated with the project.

Revenues and cost savings should be estimated conservatively. The net present value of each project will be calculated by summing the discounted values of the annual net project cash flows over the life of the project.

Assignment of Responsibilities

The Vice President for Administration and Finance, acting as University treasurer, is responsible for all debt management.

Facilities

Facilities Management is responsible for estimating and defining capital project costs and maintaining a list of projects that are being considered. Campus and Space Planning is responsible for developing capital planning documents for the current year, current biennium and the six-year capital plan.

Comptroller's Office

The Comptroller's Office will maintain a schedule of current and forecasted debt (both external and internal) and associated payment of principal, interest and fees. This office is responsible for the administration of all aspects of debt financing, including accounting, reporting and coordination with financial advisors, underwriters and bond counsel to issue new debt or refinance existing debt. Post-issuance compliance is also the responsibility of the Comptroller's Office.

Debt Management Committee

A debt management committee consisting of the following members, and any other individual designated by the Vice President for Administration and Finance, will correspond on a regular basis to review the University's external and internal debt capacity, liquidity measures and projects requested to be funded in whole or in part with debt.

- Vice President for Administration and Finance
- Comptroller
- Senior Director, Budget Office
- Director, Procurement Services
- Investment/Financial Reporting Systems Manager

Projects to be considered must be submitted to the committee by the appropriate Vice President. The Vice President for Administration and Finance will present the committee's recommendations to the President.

Board of Regents

The Board of Regents will review and approve the implementation of this Debt Policy and will be apprised of any significant future changes proposed. In addition, the Board will review and approve the annual capital project plan, all external debt financing transactions and any internal financing transactions in excess of \$500,000.

Review of Debt Policy

The Debt Policy will be reviewed at least every five years by the Debt Management Committee designated above and changed as needed. Significant changes in the University's financial health or the credit market in general will also prompt a review of the Policy.

However, it is noted that consistent application of the University's Debt Policy provides evidence of debt management discipline over the long term. Accordingly, the Policy should be changed only when it no longer reflects the debt philosophy of the University.

Debt Management Practices

Structure and maturity

The University will issue bonds to finance capital projects under the provisions of trust indentures approved by the Board of Regents. The following trust indenture have been approved by the Board of Regents:

- General Receipts Obligation Revenue Bonds
- Consolidated Educational Building Revenue Bonds
- Consolidated Housing and Dining System Revenue Bonds

Debt in the form of capitalized lease obligations will be approved by the Board of Regents and issued on behalf of the University by the Commonwealth of Kentucky's Asset Liability Commission, the State Property and Buildings Commission and other financing entities.

The University will employ maturity structures that correspond with the life of the facilities financed, generally not to exceed 20 years. As market dynamics change, maturity structures should be reevaluated. Call features should be structured to provide the highest degree of flexibility relative to cost.

Office of Financial Management

The Commonwealth of Kentucky's Office of Financial Management, in accordance with Kentucky's Revised Statute 42.400, shall review and approve, prior to issuance, all proposed bond issues, bond anticipation notes or interim external debt financings.

Refunding targets

The University will continuously monitor its outstanding tax-exempt debt portfolio for refunding and/or restructuring opportunities.

For stand-alone refundings, the University will enter into an advance refunding transaction that, in general, produces at **least a 1.5-3% present** value savings (based on refunded bonds), with this threshold higher for those transactions with a long escrow period.

Advance refunding transactions must weigh the current opportunity against possible future refunding opportunities.

For current refundings, the University will consider transactions that, in general, produce at **least a 1.5-3% present** value savings (based on refunded bonds). In addition to the net present value percentage savings, the annual dollar savings provided by any refunding will be reviewed, as for large refunding transactions, significant savings may accrue even though the percentage of net present value savings falls below the thresholds defined above.

A refunding also will be considered if it relieves the University of certain limitations, covenants, payment obligations or reserve requirements that reduce flexibility. The University also will consider refinancing certain obligations within a new money offering, even if savings levels are minimal, in order to consolidate debt into a general revenue pledge and/or reduce the administrative burden and cost of managing many small outstanding obligations.

Methods of sale

The University will use the method of sale which will achieve the lowest cost of capital considering the complexity of the transaction. Generally, this can be achieved utilizing a competitive sales method for the placement of bond offerings. However, for transactions using new or non-traditional pledges of the University's revenues, or those involving greater complexity, a negotiated method of sale will be considered, and legislative approval requested, on an individual transaction basis. The negotiated sales method allows the utilization of a greater scope of services from the underwriting community.

Selection of financial advisors, underwriters, and bond counsel

The University has authority to utilize the financial advisors and bond counsel that are under contract with the Commonwealth. The University may opt to utilize a Request for Proposal process to select financial advisors, underwriter's and bond counsel, in accordance with [Kentucky Revised Statute \(KRS\) 45A.840](#). Multiple firms may be selected to provide financial advisory, underwriting and bond counsel services for a specific contract period of time. The firms utilized on an individual transaction will be selected based upon expertise related to the specific transaction. Additionally, the University may utilize the financial advisors, underwriters and bond counsel selected by the Commonwealth of Kentucky's Office of Financial Management through their own similar competitive process.

Compliance

Bond proceeds investment

The University, in concert with the Commonwealth of Kentucky's Office of Financial Management, will invest bond-funded construction funds, capitalized interest funds and costs of issuance funds appropriately to achieve the highest return available under arbitrage limitations.

Disclosure

The University will continue to meet its ongoing disclosure requirements in accordance to [Securities and Exchange Commission Rule 15c2-12](#). The University will submit financial reports, statistical data and any other material events as required under outstanding bond indentures.

Arbitrage

The University will comply with federal arbitrage requirements on invested tax-exempt bond proceeds, causing arbitrage rebate calculations to be performed every five years and rebate payments to be remitted to the Internal Revenue Service periodically, as required.

Private use

Use of bond-financed facilities will be reviewed annually to ensure compliance with Internal Revenue Service regulations. This review will include how the facilities are used, review of management and service contracts and the population permitted to use the facilities.

Appendix

Definitions

Advance refunding: a refunding in which the refunded issue is retired more than 90 days after the refunding bonds are sold.

Bank qualified: the designation given to a public purpose issue, by the issuer, if it reasonably expects to issue no more than \$10 million par amount of debt within the calendar year of the issue.

Call features: the terms of the bond contract giving the issuer the right or requiring the issuer to redeem or "call" all or a portion of an outstanding issue of bonds prior to their stated dates of maturity at a specified price, usually at or above par and stated as a percentage of the principal amount called.

Current refunding: a refunding in which the refunded issue is retired within 90 days of the new issue sale.

Formulas for the Key Ratios

1. Ratios That Provide Information About the University's Overall Financial Health

See section III below for definitions of items referenced in the footnotes.

a. ***Primary Reserve Ratio***

$$\frac{\text{EXPENDABLE NET ASSETS }^1}{\text{TOTAL EXPENSES }^2}$$

b. ***Return on Net Assets Ratio***

$$\frac{\text{CHANGE IN TOTAL NET ASSETS }^3}{\text{TOTAL NET ASSETS, BEGINNING OF THE YEAR }^3}$$

c. ***Net Operating Revenue Ratio***

$$\frac{\text{NET OPERATING INCOME }^4}{\text{TOTAL REVENUES }^5}$$

d. Viability Ratio

$$\frac{\text{EXPENDABLE NET ASSETS}^1}{\text{LONG-TERM DEBT (BONDS AND CAPITAL LEASES)}^6}$$

2. Ratings Indicator Ratios

a. Unrestricted Net Assets to Operating Expenses (times coverage)

$$\frac{\text{UNRESTRICTED NET ASSETS}^7}{\text{TOTAL OPERATING EXPENSES}^8}$$

Expendable Net Assets to Operating Expenses (times coverage)

$$\frac{\text{EXPENDABLE NET ASSETS}^1}{\text{TOTAL OPERATING EXPENSES}^8}$$

b. Unrestricted Net Assets to Debt (times coverage)

$$\frac{\text{UNRESTRICTED NET ASSETS}^7}{\text{DEBT}^6}$$

Expendable Net Assets to Debt (times coverage)

$$\frac{\text{EXPENDABLE NET ASSETS}^1}{\text{DEBT}^6}$$

c. Debt Service Coverage (times coverage)

INCOME BEFORE OTHER REVENUES, EXPENSES, GAINS OR LOSSES +
DEPRECIATION EXPENSE +
INTEREST ON CAPITAL ASSET -
RELATED DEBT

REDUCTION IN TOTAL BONDS =
REDUCTION IN TOTAL NOTES AND CAPITAL LEASES +
INTEREST ON CAPITAL ASSET -
RELATED DEBT

3. Internal Ratios

a. Outstanding Debt per Student

$$\frac{\text{DEBT}^6}{\text{FALL FTE}^9}$$

b. Debt Service per Student

$$\frac{\text{ANNUAL DEBT SERVICE}^{10}}{\text{FALL FTE}^9}$$

c. Unrestricted Net Assets per Student

$$\frac{\text{UNRESTRICTED NET ASSETS}^7}{\text{FALL FTE}^9}$$

II. ENTITIES AFFECTED

All debt financing activities of Northern Kentucky University (the “University”). The Northern Kentucky University Research Foundation (the “Research Foundation”) is covered by this Policy as an affiliated component unit of the University. However, the legally separate Northern University Foundation (the “Foundation”) is not covered by this Policy. It is noted that, although this Debt Policy does not apply to the Foundation, the debt and operations of the Foundation impact the University’s overall credit rating.

III. DEFINITIONS/FOOTNOTES

¹ **Expendable net assets:** University’s unrestricted net assets plus restricted expendable net assets plus Foundation’s unrestricted net assets plus temporarily restricted net assets less net investment in plant.

² **Total expenses:** University’s operating expenses plus non-operating expenses plus Foundation’s total expenses.

³ Includes both the University and Foundation

⁴ **Net operating income:** University’s operating income/(loss) plus net non-operating income/(expenses) plus Foundation’s change in unrestricted net assets

⁵ **Total revenues:** University’s total operating revenues plus non-operating revenues (excludes capital appropriations and gifts) plus Foundation’s unrestricted revenues

⁶ **Debt:** University’s Consolidated Educational Building Revenue Bonds, Housing & Dining System Revenue Bonds, capital leases, and notes payable plus Foundation’s notes payable

⁷ **Unrestricted net assets:** University’s unrestricted net assets

⁸ **Total operating expenses:** University’s operating expenses per SRECNA, less student financial aid expense plus interest on capital asset related debt

⁹ **Fall FTE:** Fall semester full-time students plus the full-time equivalent of part-time students (part-time credit hours divided by full-time course load, by level). This calculation utilizes the Moody’s definition of FTE.

¹⁰ **Annual debt service:** University’s actual annual principal and interest payments for the Consolidated Education Building Revenue Bonds, Housing & Dining System Revenue Bonds, capital leases, and notes payable plus the Foundation’s actual principal and interest payments for notes payable.

REVISION HISTORY

REVISION TYPE	MONTH/YEAR APPROVED
Formatting & Minor Editing for Readability	August 7, 2019
New Policy	August 11, 2012