POLICY & PROCEDURE DOCUMENT

NUMBER: 3.1301

DIVISION: Finance & Administration

TITLE: Comprehensive Debt Policy

DATE: December 1, 2015

Authorized by: K. Ann Mead, Sr. VP of Finance & Administration
Issued by: Division of Finance & Administration

I. Purpose and Scope

To fulfill its vision to become a leading American university with international reach, Western Kentucky University will need to make ongoing capital investments in facilities. These investments will enhance the educational experience of students and foster the pursuit of knowledge from research and scholarly activity. The purpose of this policy is to provide general guidance on the strategic use of debt as a funding source. The amount and type of debt incurred impacts the financial health of the University and its credit rating. In a tight fiscal environment its use should be limited to only those projects that fulfill the mission and strategic objectives of the University.

The Sr. Vice President for Finance & Administration, in consultation with the Debt Management Advisory Committee, is directly responsible for capital debt management. This policy provides a framework that will be used by management and the Debt Management Advisory Committee to monitor the university's credit rating and to evaluate the appropriate use of debt in financing plans. For purposes of this policy, debt may include bonds, operating and capital lease obligations with maturities exceeding seven years, revenue pledges, and any other financial obligations used to finance capital assets including third-party asset financing arrangements, The Board of Regents formally approves actions to issue debt based on recommendations from the University President.

II. Policy

A. Objectives

- Maintain a debt credit rating sufficiently high to provide the financial flexibility to access capital markets at advantageous borrowing costs. The attainment or maintenance of a specific credit rating itself is not an objective of this policy.
- Define quantitative tests that will be used to evaluate the University's overall financial operations and debt capacity.
- Assist in evaluating debt financing for capital projects with assurance the debt financed project has a dedicated revenue stream and a viable plan for repayment.
- Identify nonfinancial variables to be considered before issuance of additional debt.
- Consider decisions regarding term and structure of debt issuances.
- Establish criteria used to identify refunding opportunities.
- Assign responsibility for providing continuing disclosure information.

B. Ratios

The University will establish guidelines for overall debt management using a select number of financial ratios that are calculated annually and when new debt is issued. Financial ratios will serve as general indicators of the University's financial health and capacity to incur debt. Calculation of these ratios will be based on the audited financial statements of WKU and may include analysis of the debt obligations of related foundations as appropriate.

Ratios fall into two specific categories: (a) financial ratios that provide information about the overall financial health of the University; and (b) ratings indicator ratios that are specific to the ability to issue debt and are key determinants used by rating agencies in rating the University's bonds.

RATIOS THAT PROVIDE INFORMATION ABOUT THE UNIVERSITY'S OVERALL FINANCIAL HEALTH

The following four strategic financial ratios, when considered together and over time, will provide an assessment of the overall financial health of the University. Please see Appendix A for ratio formulas.

1. **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 resources without relying on additional net assets generated by operations. A negative ratio or decreasing trend over time indicates a weakening financial condition.
2. **Return on Net Assets Ratio.** Determines whether the University is financially better, or worse, than in previous years by measuring total economic return.
3. **Net Operating Revenue Ratio.** Indicates whether total operating activities resulted in a surplus or a deficit and measures the ability of the University to operate in the short term.

4. **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.

RATINGS INDICATOR RATIOS

In addition to the four strategic financial ratios, there are many other ratios used by bond rating agencies. 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 most important ratings indicator ratios. Please see Appendix A for ratio formulas.

1. **Unrestricted Resources (Net Assets) to Operating Expenses** (times coverage) *and* **Expendable Resources (Net Assets) to Operating Expenses** (times coverage). These two balance sheet ratios provide indicators 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.
2. **Unrestricted Resources (Net Assets) to Debt** (times coverage) *and* **Expendable Resources (Net Assets) to Debt** (times coverage). These two capital ratios measure the University's liquid assets to its debt.
3. **Peak Debt Service to Operating Expenses** (percentage). Measures the University's longer term debt and related operating flexibility.
4. **Operating Margin** (percentage). Measures the University's excess margin (or deficit) by which revenues cover expenses (including depreciation of capital assets and interest expense) annually, and averaged over a three year period.
5. **Direct Debt to Cash Flow** (times coverage). Measures the total debt burden compared to its annual cash flow generating ability.
6. **Cash Flow Operating Surplus** (percentage). Measures total operating surplus (operation surplus, depreciation, and interest on capital related debt) as a percent of total revenue.
7. **Days Cash on Hand**. Measures number of days' operating expenses that can be paid with cash on hand.

C. Project Specific Quantitative Tests

Every project considered for debt financing must have a management-approved plan of project costs, including incremental operating expenses and revenues (e.g., usage fees, student fees). Each project must have an identifiable and measurable source of repayment.

D. Nonfinancial indicators

Consideration of the ratios calculated above will contribute to the assessment of the ability and/or advisability of issuing additional debt from a University-wide perspective. In addition to the ratios described above, other nonfinancial indicators such as enrollment and student demand data will be taken into consideration when determining whether issuance of additional debt is advisable.

III. Procedures

A. Prioritizing Capital Projects Requiring Debt

Determination of procedures used to prioritize capital projects to be allocated a portion of available debt capacity is addressed through the University's six-year Capital Plan development process.

Every project considered for financing must have a defined, supportable budget for construction and operating costs. If appropriate, a written plan to fund debt service should be developed and signed by appropriate parties to acknowledge financial commitments.

B. Terms and Structure

Method of Sale – Both negotiated and competitive debt offerings may be considered on a case by case basis.

Financial Advisor – The University will select a Bond Financial Advisor for each bond issuance that has been pre-qualified by the Commonwealth of Kentucky Office of Financial Management (OFM).

Bond Counsel – The University will select Bond Counsel for each bond issuance that has been pre-qualified by the Commonwealth of Kentucky Office of Financial Management (OFM).

Tax-Exempt and Taxable – The University's debt will be managed to use tax-exempt debt to the greatest extent possible while recognizing that taxable debt must be used in the case of projects that are ineligible for tax-exempt financing.

Amortization – Bond amortization will never be greater than the estimated useful life of the assets or project being financed. Generally a capital asset should not be financed for a term greater than 20 years.

Call Provisions – Call features should provide maximum flexibility relative to the cost of the features. Generally, call provisions should be as favorable to the University as the market will allow.

C. Refunding

The University will monitor its outstanding debt for refunding and restructuring opportunities. Any refunding should produce a minimum net present value savings of five percent (5%) based on the refunded bonds, unless the transaction provides relief from overly restrictive covenants or excessive reserve requirements.

D. Continuing Disclosure Obligations

In accordance with Securities and Exchange Commission Rule 15c2-12, the University must agree, pursuant to a Continuing Disclosure Agreement, to provide, or cause to be provided by its Disclosure Agent, certain information to the public. Such information and related notification should be provided to the Disclosure Agent in a timely manner by the university's Chief Financial Officer.

IV. Policy Review

At least every five years, but may be reviewed at any time the University's or credit market's situation changes substantially.

Appendix A
Formulas for Key Ratios

RATIOS THAT PROVIDE INFORMATION ABOUT THE UNIVERSITY'S OVERALL FINANCIAL HEALTH

1. PRIMARY RESERVE RATIO

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

2. RETURN ON NET ASSETS RATIO

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

3. NET OPERATING REVENUES

OPERATING INCOME (LOSS) + NET NON-OPERATING INCOME (EXPENSES)
TOTAL OPERATING REVENUES + TOTAL NON-OPERATING REVENUES (EXCLUDING CAPITAL APPROPRIATIONS & GIFTS, AND ADDITIONS TO PERMANENT ENDOWMENTS)

4. VIABILITY RATIO

$$\frac{\text{EXPENDABLE NET ASSETS}}{\text{LONG TERM DEBT (BONDS, PLEDGES PAYABLE AND CAPITAL LEASES)}}$$

---

[1] Expendable net assets = unrestricted net assets plus expendable restricted net assets less expendable assets to be invested in plant.
[2] Total expenses = operating expenses plus non-operating expenses

RATINGS INDICATOR RATIOS

1A. UNRESTRICTED RESOURCES (NET ASSETS) TO OPERATING EXPENSES (TIMES COVERAGE)

UNRESTRICTED NET ASSETS
TOTAL OPERATING EXPENSES[3]

1B. EXPENDABLE RESOURCES (NET ASSETS) TO OPERATING EXPENSES (TIMES COVERAGE)

EXPENDABLE RESOURCES[4]
OPERATING EXPENSES

2A. UNRESTRICTED RESOURCES (NET ASSETS) TO DEBT (TIMES COVERAGE)

UNRESTRICTED NET ASSETS
DEBT[5]

2B. EXPENDABLE RESOURCES (NET ASSETS) TO DEBT (TIMES COVERAGE)

EXPENDABLE RESOURCES
DEBT

3. PEAK DEBT SERVICE TO OPERATING EXPENSES (%)

MAXIMUM ANNUAL PRINCIPAL AND INTEREST ON ALL DEBT
TOTAL OPERATING EXPENSES

[3] Total operating expenses=operating expenses per SRECNA, less student financial aid expense plus interest on capital asset related debt.
[4] Unrestricted net assets plus expendable restricted net assets
[5] Par amount of debt=total of long-term obligations, including Capital Lease obligations, General Receipts Bonds, Pledges Payable and other long-term obligations.

4. OPERATING MARGIN (PERCENTAGE)

$$\frac{\text{ANNUAL OPERATING MARGIN}^{6}}{\text{TOTAL OPERATING REVENUES}^{7}}$$

5. DIRECT DEBT TO CASH FLOW (TIMES COVERAGE)

$$\frac{\text{DEBT}}{\text{OPERATING MARGIN + DEPRECIATION AND INTEREST EXPENSE}}$$

6. CURRENT YEAR OPERATING SURPLUS (PERCENT)

$$\frac{\text{OPERATING SURPLUS + DEPRECIATION + INTEREST ON CAPITAL RELATED DEBT}}{\text{TOTAL OPERATING REVENUE}}$$

7. DAYS CASH ON HAND

$$\frac{\text{UNRESTRICTED CASH + CASH EQUIVALENTS}}{\text{(OPERATING EXPENSES – DEPRECIATION)/365}}$$

[6] Annual operating margin = net (loss) from operations per SRECNA + state appropriations + grants & contracts revenues

[7] Total operating revenues = operating revenues per SRECNA + state appropriations + grants & contracts revenues