McMaster University

Policies, Procedures and Guidelines

Complete Policy Title: **Debt Management Policy**	Policy Number (if applicable): **n/a**
Approved by: **Board of Governors**	Date of Most Recent Approval: **April 16, 2015**
Date of Original Approval(s): **December 13, 2007**	Supersedes/Amends Policy dated: **June 7, 2012** **December 13, 2007** **December 12, 2002 (Private Placement Bond Management Policy)**
Responsible Executive: **Vice-President (Administration)**	Enquiries: **Policy (University Secretariat)**
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SECTION I - PREAMBLE

This document serves to outline the application and use of external debt by McMaster University. This policy further outlines internal methods used for the assessment of proposed projects and internal loans.

Since capital projects will continually require a combination of financing sources including internal reserves, external debt, gifts, future revenue streams, grants and deferred contributions, debt will be considered a perpetual component of the University's capital structure. The specific amounts, types and uses of debt will be selected to help the University achieve the lowest cost of capital consistent with the University's risk tolerance profile.

SECTION II - OBJECTIVES

In order to ensure that debt and University reserves are used prudently, the University will give higher priority to capital projects that are considered mission-critical and/or self-supporting.

The strategic use of debt will be aligned with the University's investment policies to manage the overall cost of capital and limit the level of risk. Bridge financing, derivative products, long term fixed and variable rate debt will all be considered to achieve this goal of risk reduction and reduced cost of capital. In determining different debt strategies, McMaster will take into account the University's assets, liabilities and market conditions when evaluating different debt strategies and instruments.

This policy will help guide the University's on-going relationship with the rating agencies, bond purchasers and external constituents by providing continuous communication and education.

SECTION III - ESTABLISHMENT OF POLICY RATIOS

The University has established guidelines regarding the optimal amount of outstanding debt through monitoring University-wide ratios. These ratios measure University balance sheet resources and annual cash flow. They can be derived from the University's financial statements and are subject to review periodically.

- *a) Ratio 1 – Available Expendable Resources-to-Debt Ratio:* This ratio measures balance sheet leverage by comparing University unrestricted equity to outstanding debt obligations.

$$\frac{\text{UNRESTRICTED NET ASSETS + SPECIFIC PURPOSE FUNDS+ INTERNALLY RESTRICTED ENDOWMENTS}}{\text{TOTAL UNIVERSITY DEBT}} \qquad \geq 0.6\text{x to } 1.0\text{x coverage}$$

  Management has established an acceptable range of 0.6x to 1.0x (times) coverage. If total debt exceeds 1.67 (1/0.6) times the University's available expendable resources capacity to devote resources to fund other objectives is lower.

- *b) Ratio 2 – Interest Coverage:* This ratio indicates a key determinant of debt affordability as it quantifies the ability for operating revenues to repay the University's current and potential interest burden. Note that interest expense and amortization are credited back to operating revenues since the ratio compares revenues to current debt-related expense.

(EXCESS OPERATING REVENUES +

$$\frac{\text{INTEREST EXPENSE+ AMORTIZATION OF CAPITAL - AMORTIZATION OF DEFERRED REVENUES RELATED TO CAPITAL ASSETS)}}{\text{INTEREST EXPENSE}}$$

The acceptable range for interest coverage is 2.75 to 3.25x (times) interest expense to ensure significant coverage is available without jeopardizing potential funds available for other internal purposes. Results in excess of 3.25x indicate an ability to afford new debt.

- *c) Ratio 3 – Available Expendable Resources as a Percentage of Revenue:* Available expendable resources represents funds held that are not externally committed, such as unrestricted net assets and internally restricted endowments and specific purpose funds. Management shall ensure that the available expendable resources maintained are at minimum equal to:

$$\frac{\text{UNRESTRICTED NET ASSETS + INTERNALLY RESTRICTED ENDOWMENTS AND SPECIFIC PURPOSE FUNDS}}{\text{REVENUE}} > 15\%$$

This ratio is to ensure the University has the flexibility to fund capital projects or new loans.

- *d) Ratio 4 – Liquidity Ratio-:* The liquidity ratio measures total university liquidity. Management shall ensure that the cash and short term investments, as well as available lines of credit are greater than one month's expenditures. The proposed measurement is as follows:

$$\frac{\text{CASH AND EQUIVALENTS + AVAILABLE LINES OF CREDIT}}{\text{EXPENSES/12}} > 1.00$$

This ratio is to ensure the University has sufficient liquidity.

Additional ratios, including debt-to-FTE, will be monitored in order to provide management with a more complete understanding of the University credit and financial profile. The ratios and limits are not intended to track a specific rating, but rather will ensure the maintenance of the University's competitive financial profile, funding for internal facilities needs and reserves, and maintenance of financial equilibrium.

SECTION IV – COMPLIANCE WITH BOND COVENANTS

At the time of review and approval of the Annual Financial Statements of the University, the Audit Committee will review a report that documents the University's compliance with all covenants and obligations associated with any outstanding bonds, including the punctual payment of debt service.

Interest payments will be funded through a combination of operating funds (exclusive of operating grants), ancillary funds, capital funds and investment income, as needed from the sinking fund described below. The University will clearly specify the source of funding for interest payments along with annual costs (trustees, credit rating fees, etc.) in the multi-year financial plan approved by the Board of Governors and the Annual Operating and Ancillary Budget approved by the Board of Governors.

SECTION V – PROJECT APPROVALS, LOANS AND SINKING FUND

Project Approvals: Since capital projects are the primary driver for capital needs, the University has supplemented its capital project review process with the creation of a Project Priorization Policy to assure that

approved projects enable the University to remain within the constraints of the current and projected financial ratios of the University. The review process will increase the University's diligence in evaluating project proposals, which should include a description outlining how the project furthers the mission of the University along with a capital budget for the project, including appropriate contingencies for fundraising and construction. Project proposals will also include, at a minimum, annual revenue and expense estimates, including impact on deferred maintenance, so that the on-going impact on University finances can be appropriately assessed. Projects which require less debt financing and projects with projected or established revenues to support on-going expenses along with incremental additional revenues to service the debt obligation will take priority over those projects that cannot support on-going operations and/or debt service associated with said project.

Loans: The University will maintain uniform guidelines for internal loans, regardless of source of funding, for projects which require internal or external University loans. These guidelines will include amortization, prepayment terms and a University-wide blended interest rate reflecting the University's overall cost of capital and cost of administering the loan. To the extent that internal loan payments are not needed to pay annual debt service in a given year, they will be deposited into an internally restricted fund which can be used either to fund additional loans/projects, or to pay debt service in the future, including principal.

Sinking Fund: The sinking fund is designed to provide sufficient funds to repay principal on outstanding debt, when due, and should be invested with the objectives of :

- Maximizing investment earnings over the time horizon and to achieve a minimum annual average rate of return at least equal to the blended rate on the University's debt over the life of the fund.
- Provide appropriate diversification of asset mix to ensure prudent and effective management of the funds.

Based on the long time horizon that exists for the sinking fund, the University has determined that the sinking fund has a moderately high tolerance of investment risk. Therefore, a long-term asset mix strategy with relatively high equity content has been adopted and the sinking fund will continue to be invested within the McMaster University Investment Pool. As such, the Investment Pool's Statement of Investment Policies and Objectives will govern the administration and investment management of the sinking fund.

On an annual basis, the Finance Committee will review the sinking fund value, combined with the accumulated realized and unrealized investment gains and losses allocated to the sinking fund. The Finance Committee will also review the ability of the internal loans, together with the sinking fund value, to support the on-going debt service of the University, and review the calculation of the blended rate. The review will include the objectives of the sinking fund with respect to time horizon and risk tolerance and a re-evaluation of the investment strategy.

SECTION V – REVIEW AND OVERSIGHT FOR THIS POLICY

This debt management policy will be reviewed annually to remain consistent with the University's objectives and the external environment. The Finance Committee will have on-going oversight and regularly review the asset and liability structure related to this policy. The Committee may recommend revisions to the policy in the future if deemed desirable. The structure of any individual transaction will be based upon overall University needs to ensure that long-term costs are minimized consistent within the context of other strategic objectives and overall risk does not exceed acceptable levels.

At a minimum, management will report the historical debt management policy ratios to the Finance Committee on an annual basis. In addition, management will include a ten-year debt projection in the annual multi-year

projection analysis reported to the Finance Committee annually to monitor debt capacity, affordability and flexibility and to evaluate the need and timing of additional external debt.

Where any two of the historical debt policy ratios do not meet the established targets or where any two of the projected debt policy ratios do not meet the established debt policy ratios, management will undertake a more comprehensive review and provide a report with recommendations to Finance Committee.