Internal Lending Program Update

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U. T. System Board of Regents' Meeting
Finance and Planning Committee
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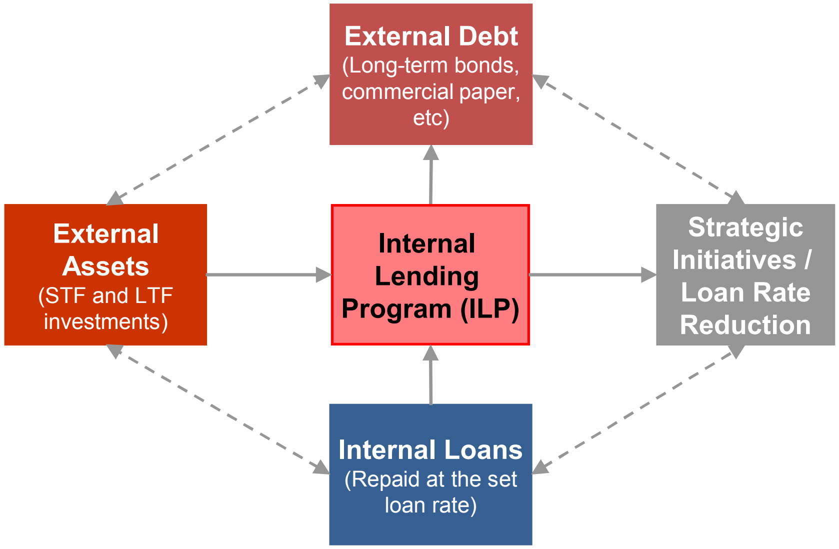
Executive Summary

- An internal lending program allows institutions to manage resources across the entire institution, rather than through individual departments or schools.

- The concept has been utilized by many other major research universities (Harvard, Duke, UNC, Virginia, Cornell, Columbia, Emory, Ohio State, MIT, etc.) as a way to provide uniform internal lending rates with reduced interest cost volatility, to better optimize capital market borrowing, and to generate centralized funds for strategic initiatives.



UNC = University of North Carolina
MIT = Massachusetts Institute of Technology

STF = Short Term Fund
LTF = Long Term Fund

U. T. System ILP Benefits

- The primary benefits of the ILP that were unavailable under the prior lending approach:
  - **Provide uniform lending rates and terms** across the U. T. System with institutions assuming less interest rate risk compared to current practices, where institutions and their underlying projects bear the cost of capital at the time of borrowing.
  - **Use a portfolio approach** to better distribute debt portfolio risks across the institutions and underlying projects versus each project assuming risks of a particular financing structure. This portfolio approach provides a mechanism to enable U. T. System Administration to take advantage of more optimal debt structures that are not directly tied nor appropriate for individual projects or borrowers.
  - **Minimize the need to issue taxable debt** for projects that, under the current debt issuance process, cannot be financed on a tax-exempt basis due to private business use restrictions.
  - **Increase funds available for strategic initiatives and long-term investment** by delinking the external and internal debt structure. U. T. System Administration can then create a pool of liquidity to either invest or relend internally depending on market conditions.
  - **Create a more sustainable and efficient debt management process** for both U. T. institutions and System Administration and eliminate negative arbitrage for U. T. institutions.
  - **Reduce the number of accounting transactions** by simplifying the debt service billing and accounting processes.

ILP Implementation

- The ILP was implemented at the start of fiscal year 2016 under the following conditions:
  - All projects previously financed with long-term Revenue Financing System (RFS) bonds were "grandfathered" to be cash flow neutral on an annual basis[1].
  - All new projects were financed at the blended rate of 4.50%[2] upon reaching substantial completion.
  - Capital projects in construction and capital equipment are financed at the average commercial paper rate plus a premium, initially set at 0.75%.
  - Excess funds generated through value-add transactions are to be used only to fund strategic initiatives for the benefit of U. T. institutions as recommended by the Chancellor and approved by the Board. All proceeds go to the campuses.
- Previously, all savings derived through centralized debt management were passed directly to the U. T. institutions as they were realized, but the allocation of certain transactions was difficult to allocate to specific borrowers.
  - Under the new structure, the savings is aggregated and used to lower the blended rate for all institutions and to fund strategic initiatives at various U. T. institutions.

[1] Due to rounding, there may be slight differences in annual debt service.
[2] For projects that do not comply with IRS private business use restrictions, an additional use flexibility premium is added to cover the incremental cost of taxable debt.

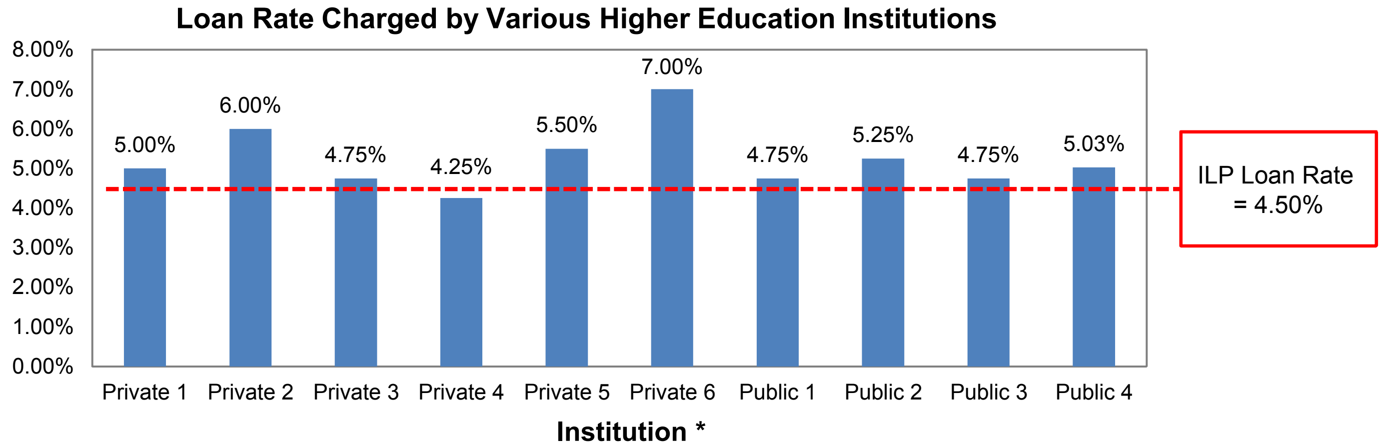
Transparency in ILP Implementation

The U. T. System ILP was discussed on multiple occasions with various constituencies before the proposal was presented and approved by the Board of Regents.

August 4, 2015	ILP presented to the Chief Business Officers at the Business Management Council Meeting
August 25, 2015	Chancellor distributed letter and FAQ document to all Presidents regarding ILP implementation
September 1, 2015	Chancellor and Dr. Kelley briefed the Board Chairman and Vice Chairmen during a regularly scheduled Finance and Planning Committee video teleconference about the November 2015 proposed Internal Lending Program agenda item
September 9, 2015	ILP presented to the Presidents of the academic institutions during the Chancellor's biweekly video teleconference with the Presidents
September 30, 2015	ILP presented to the Presidents of the health institutions during the Chancellor's biweekly video teleconference with the Presidents
November 5, 2015	Board of Regents approved the U. T. System Internal Lending Program

Loan Rates Charged by Other Research Universities

- Other research universities utilizing an ILP structure currently lend at interest rates ranging from 4.25% to 7.00%.
- The initial ILP loan rate of 4.50% was among the lowest lending rate across peer institutions.

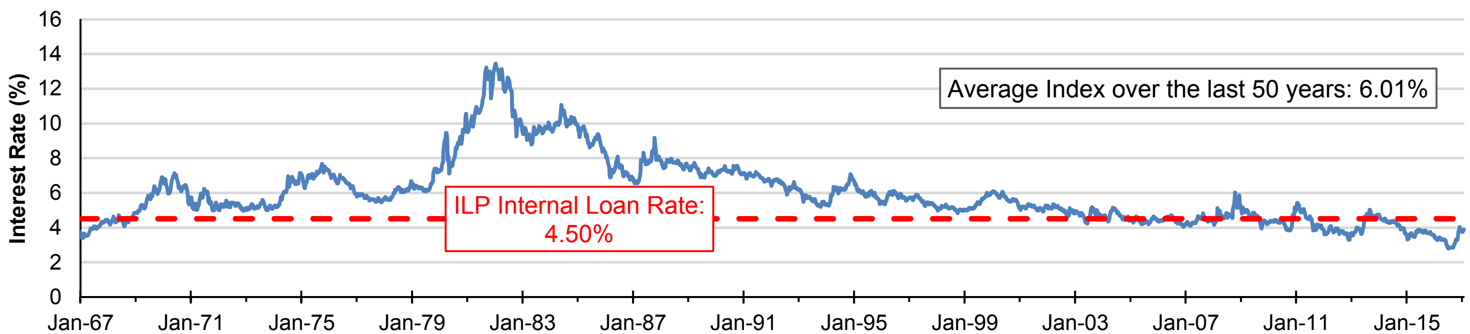


* Identities of higher education institutions removed for confidentiality reasons.

ILP Lending Rate in Historical Context

- Over the last fifty years, the average interest rate of the Bond Buyer 20-Bond General Obligation Index exceeds 6.0%.
- The initial ILP lending rate of 4.50% is in the bottom quartile of rates over the last fifty years.
- One of the primary objectives of the ILP is to maintain a stable lending rate; the ILP is in essence providing a perpetual cap on interest rates for the benefit of U. T. institutions.

Bond Buyer 20-Bond General Obligation Index[1]

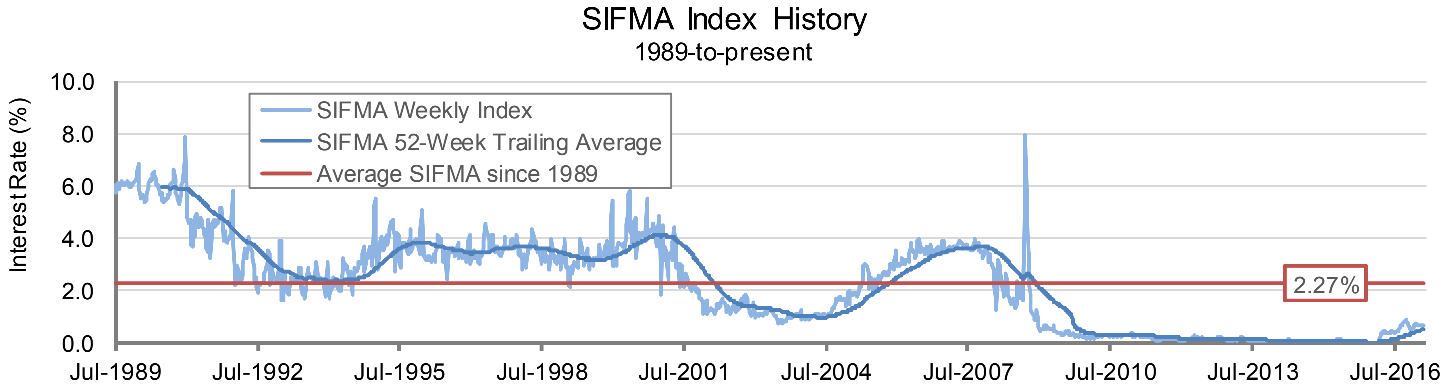


[1] The 20-Bond Index consists of 20 general obligation bonds that mature in 20 years. The average ratings of the 20 bonds is roughly equivalent to Moody's Investors Service Aa2 rating and Standard & Poor's Corp.'s AA.

Note: Although the 20-Bond Index illustrated above is not necessarily indicative of the System's Aaa/AAA absolute borrowing rate, the graph illustrates the relative level of actual long-term interest rates by institutional borrowers in a historical context.

ILP Portfolio Value-Add Benefit

- The implementation of the ILP allows the System to take a more portfolio-driven approach to add significant value to the institutions. For example, the use of long-term variable-rate debt can potentially reduce the cost of capital for all institutions, but it is rarely appropriate for any single project that would have been subject to variable-rate fluctuations under the prior pass-through model.



[1] The Securities Industry and Financial Markets Association Municipal Swap Index ("SIFMA Index") is a 7-day high-grade market index comprised of tax-exempt Variable Rate Demand Obligations (VRDOs) with certain characteristics (such as size, of the highest short-term rating) and is calculated and published by Bloomberg, overseen by SIFMA's Municipal Swap Index Committee.

Note: Although the SIFMA Index illustrated above is not necessarily indicative of the System's Aaa/AAA absolute short-term borrowing rate, the graph illustrates the relative level of actual short-term interest rates by institutional borrowers in a historical context.

Internal Lending Program Background

- The Internal Lending Program was approved by the Board of Regents in November 2015.
- The ILP only involves projects to be financed with RFS debt and excludes PUF debt and TRB debt.
- ILP Strategic Goals:
  - Use a portfolio approach to better distribute debt portfolio risks
  - Provide uniform lending rates and terms across projects and institutions
  - Minimize the need to issue taxable debt
  - Increase funds available for strategic initiatives and long-term investment
  - Create a more sustainable and efficient debt management process
  - Accounting simplification

PUF = Permanent University Fund
TRB = Tuition Revenue Bond

Successful ILP Implementation

- The ILP has had a very successful implementation and is exceeding original expectations.
- Due to this success, the U. T. System Office of Business Affairs will be reducing the ILP loan rates for the fiscal year beginning September 1, 2017.
- Even with planned rate reduction, the ILP is expected to continue to generate $15 million annually for use by the Board of Regents to fund strategic initiatives.

Various Sources of Value-Add

- The U. T. System Office of Finance has added a significant amount of value to permit the lowering of ILP loan rates, including:

Source	Description
Derivative Transactions	- Executed forward-starting fixed-payer swap around the time of the Brexit vote to hedge future interest rate risk and to lock-in very attractive long-term funding costs. - Executed three MMD basis swaps that are expected to generate $4.4 million annually for at least ten years to further reduce interest cost. - Various swaptions and novations executed over last five years have generated $3.6 million to date. - Basis swaps generated about $2.1 million of incremental revenue during FY 2016 and is expected to continue in future years. - Positive carry on synthetic fixed-rate transactions is expected to save an additional $0.6 million in FY 2017 and increase in future years.
Refunding Transactions	- Refunded $267 million of outstanding bonds to capitalize on low interest rates to generate $48.9 million of present value debt service savings.
Long-Term Financing	- Executed various long-term transactions totaling $1.1 billion in par at all-in true interest costs ranging from 2.00% to 3.62% compared to projected levels of 3.50% to 4.25%.

Proposed ILP Rate Changes

	Current Terms	FY 2018 Recommendation
Long-Term Capital	- Quarterly principal and interest payments with 10-30 year repayment terms. - *Long-Term Rate* of 4.50%	- *Long-Term Rate* decrease from **4.50% to 4.25%**.
Flexibility Premium	- Additional premium for projects with IRS private business use restrictions.	- *Flexibility Premium* decrease from **0.75% to 0.50%**.
Grandfathered Long-Term Debt	- Fixed schedule with quarterly principal and interest payments.	No change
Equipment Loans	- Quarterly principal and interest payments with 3 to 10 year repayment terms. - *Short-Term Rate* equal to average CP rate paid by System plus *Short-Term Premium* of 0.75%.	No change
Short-Term Capital (interim financing)	- Quarterly interest payments during construction → converted to Long-Term Capital loan upon reaching Substantial Completion. - *Short-Term Rate* equal to average CP rate paid by System plus *Short-Term Premium* of 0.75%.	No change

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Funding for Strategic Initiatives

- Under current assumptions with the proposed Long-Term Rate reduction, the ILP is expecting **$15 million** of funding available annually for strategic initiatives.

FY 2017 ILP Available Funding	$15,000,000
ILP Funding Commitments-to-Date:	
- Student Success/Quantum Leap #9	($10,000,000)
- U. T. Network for National Security	($500,000)
Remaining FY 2017 ILP Available Funding	$4,500,000