

# ASU System Policy

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**Effective Date: March 10, 2023**

**Subject: Debt Management**

**Category: Financial Management 1.04**

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## **Purpose**

The Arkansas State University System (System) Debt Management Policy (Debt Policy), in coordination with the System's Bond Financing Post-Issuance Compliance Policy, establishes guidelines for the prudent use and management of debt.

Debt financing is a source of funding that allows the System to finance the cost of capital improvements for one of its component institutions over a period of time, typically related to the useful life of the asset.

The System may use debt financing for academic, administrative, and auxiliary facilities and equipment, as well as any other infrastructure needs or property acquisitions that are consistent with strategic priorities. Decisions regarding appropriate use of debt should be balanced to ensure the System's financial health – as well as the health of the System institutions – while also considering the effects of current decisions on future costs of capital and operating budgets. Adherence to the following policies will ensure that risks associated with debt issuance are effectively managed.

## **Procedures**

### **A. Affordability**

1. When issuing debt, the System will seek a source of funding available commensurate with the most favorable financial terms, conditions, and risks that are consistent with the System's capital structure and financing requirements.
2. External borrowings will be coordinated to the extent practicable, so that multiple project needs can be accomplished in a single borrowing, thereby reducing issuance costs.
3. All debt-financed projects must have an identified revenue stream (or cost reduction) and must be supported by an achievable plan of finance to provide debt service coverage and meet any new or increased operating cost.
4. The cost of debt-financed capital acquisitions should be charged to the future users of the capital asset over the period in which the debt is outstanding and

over the asset's useful life, as legally permitted. The System may, however, issue debt for a term shorter than the asset's useful life.

5. All debt payments will be prioritized and provided for in the annual operating budget.

## B. Budget Structure

1. In general, fixed-rate debt will be utilized. However, the System may utilize variable-rate debt when appropriate for a particular financing plan, taking into consideration bond market conditions, the System's liquidity position, and risks associated with variable rate debt (including interest rate risk, remarketing risk, and liquidity renewal risk).
2. The use of capitalized interest will only be considered for projects whose identified funding stream will not be able to immediately generate sufficient revenues to repay debt. In those instances, interest will not be capitalized for a period in excess of the construction period, plus three months.
3. The System's debt capacity will be determined from time to time, recognizing it as a subjective measure. Consideration should be given to bond-rating agencies and related industry guidelines. The System recognizes that strategy and mission must be the primary drivers of its use of debt. Additionally, considerations will be given to ensure that component institutions' proportional share of the consolidated long-term debt is equitable.

## C. Risk Management

1. The System will not default on its bond covenants and obligations. Meeting debt-service obligations will be prioritized over competing budgetary needs of the System and institutions, including the use of reallocations and reductions, when required.
2. The System will consider refinancing outstanding debt only when savings for the refinancing, measured on a net present value basis, are positive, or when the refinancing accomplishes other strategic objectives, including budgetary relief or reducing or eliminating future risks.
3. Negative financial covenants and restrictions will be minimized to the extent possible, taking into consideration the long-term capital requirements of the System.
4. The System's cash-flow procedures will be managed to ensure timely payment of debt service.
5. Compliance with debt reporting and financial covenants will be closely monitored and adhered to by the System Chief Financial Officer (CFO) with validation by external auditors.

6. The following risks should be addressed before issuing debt:

Change in Public/Private Use

The change in the public/private use of a project, which is funded by tax-exempt funds, could potentially cause a debt issue to become taxable.

Default Risk

The risk that revenues for debt-service payments are not all received by the due date.

Liquidity Risk

The risk that the System will not be able to meet its current and future cash-flow collateral needs, both expected and unexpected, without materially affecting its daily operations or overall financial condition.

Interest Rate Risk

For variable rate debt, the risk that interest rates will rise, on a sustained basis, above levels that would have been set if the issue had been fixed.

D. Financing Procedures

1. The CFO of the System will have responsibility for any debt financing and issuances of debt and will coordinate all related activities with the campuses. This includes drafting the authorizing resolution for approval by the System Board of Trustees. Additionally, the CFO of the System will be responsible for coordinating with the Arkansas Department of Higher Education's Institutional Finance Division to obtain approval of the economic feasibility.
2. The System Office of General Counsel has responsibility for all legal actions relating to any debt financing, including reviewing all documents and legal opinions, and determining the role of external legal counsel.
3. The institution responsible for a proposed project will provide the CFO of the System with the following information:
  - Total project cost
  - For auxiliary supported projects:
    - a. At a minimum, five-year pro forma showing all available revenues, expenses, and net revenues available to pay debt service;
    - b. A coverage ratio calculation within the pro forma applied to each project, whereby revenues for the project exceed expenses by a minimum of 25 percent;
  - Project time schedule;
  - Budget plan for increased operating costs;
  - Other information, as requested.
4. The System CFO, in conjunction with the campuses, will work with selected underwriters, financial advisors, bond counsel, rating agency, and General Counsel to develop all necessary financial resolutions, policies, procedures, projections, and documents needed to successfully finance a project before the sale of bonds.

#### E. Procedures and Approvals for Refinancing

1. The System CFO will assure that any issuance of debt is structured cost effectively and in the best interest of the System, taking into consideration the Debt Management Policy and the Bond Financing Post-Issuance Compliance Policy.
2. The System Office of General Counsel will assure that all legal opinions, bond documents, disclosure documents, and any other required legal materials are satisfactory.
3. The System CFO, in consultation with the System Office of General Counsel, will assure that all materials necessary for the Board to complete its review of the financing are provided to the Board in a timely manner.
4. The Board will approve the bond purchase agreement and other financing documents.

#### F. Post-Issuance Compliance

The Board of Trustees of the System borrows through the issuance of tax-exempt bonds to finance acquisition and construction of, and improvements to, many of its facilities and other capital projects. Investors in tax-exempt bonds are willing to accept a lower coupon rate because interest earned on the tax-exempt bonds is exempt from state and federal income tax. This exemption translates into a lower cost of capital for the System. However, various requirements must be satisfied for tax-exempt bonds to maintain their tax-exempt status.

This section explains the guidelines and practices that the System follows to comply with rules and regulations relating to tax-exempt bonds and is not intended to supersede the existing Post-Issuance Compliance Manual. Compliance is required, both upon issuance of the bonds and during the post-issuance phase, which extends through, and beyond, the life of the bonds. An exception to these guidelines may only be authorized by the System CFO, in consultation with relevant System bond counsel, based on a determination that such exception will not jeopardize the tax-exempt status of the applicable bond issue.

1. Roles, Responsibilities, and Procedures
  - a. Campus Post-Issuance Compliance Officer – In accordance with System Policy “Bond Financing Post- Issuance Compliance,” each institution in the System shall designate a representative. The duties of this compliance officer include, but are not limited to, the following:
    - i. Assure that tax-exempt bond proceeds are spent on the projects specified within the financing documents;
    - ii. Maintain appropriate documentation for allocations of bond-financing proceeds to expenditures and copies of requisitions, draw schedules,

- invoices, and cancelled checks related to bond proceeds spent during the construction period;
- iii. Assure that bond proceeds are spent within the timeline provided by the Internal Revenue Service (IRS) guidelines for tax-exempt financing;
- iv. Assure that the IRS private-use limitations are maintained for the life of the financing;
- v. Provide for arbitrage yield calculations, monitor any restrictions, and assure compliance with IRS regulations;
- vi. Provide timely reporting.
- b. School and Department Responsibilities - Institution or department senior finance officers have certain responsibilities with respect to capital projects and facilities financed with tax-exempt bonds. These individuals play a critical role in ensuring compliance with the Guidelines, and they are responsible for the accuracy and completeness of information provided to their Institution Post-Issuance Compliance Officer regarding the utilization of space. In addition, they are responsible for ensuring that their departments retain records for the appropriate timeframe. The Senior Finance Officers are designated by the respective University Post Issuance Compliance Officer.

## 2. Recordkeeping

The System seeks to comply with regulatory record-retention requirements. Good record retention and documentation provide evidence of compliance and are the foundation of a successful bond compliance program. The System Office will also retain all records relating to debt transactions for as long as the debt is outstanding, plus three years after the final redemption date of the transaction. In the event that any debt is refunded, the records shall be kept for the life of the refunding bonds, plus three years.

## 3. Generally Accepted Accounting Principles (GAAP)

The System will comply with the standard accounting practices adopted by the Financial Accounting Standards Board and the Governmental Accounting Standards Board when applicable. The System CFO shall establish operating procedures with respect to the maintenance of relevant records and shall oversee compliance with such operating procedures.

## 4. Arbitrage Compliance

Arbitrage arises when proceeds from a bond issue are invested and the yield on the investments is greater than the yield on the bonds. Negative arbitrage arises when the investment yield is less than the yield on the bonds. The Internal Revenue Service (IRS) Code contains requirements relating to arbitrage, yield restriction, and rebate that must be satisfied to ensure bonds do not lose tax-exempt status.

### a. Yield Restriction

Unless there is an exception permitted by the IRS Code, the arbitrage rules generally prohibit proceeds of a bond issue from being invested in a yield in excess of the bond yield. Bond counsel should be consulted before investing bond proceeds above the bond yield.

b. Rebate

Even if an exception to yield restriction applies and arbitrage is earned on an issue, the excess earnings must be remitted to the U.S. Treasury Department unless an exception to rebate applies.

The System's objective is to invest bond proceeds to the bond yield or higher, while minimizing arbitrage rebates to the extent permissible by rebate exceptions. Negative arbitrage is to be avoided. The System CFO works in conjunction with the University Post-Issuance Compliance Officer to establish operating procedures with respect to arbitrage investment limitations and rebate requirements on behalf of the System. The System CFO shall oversee compliance with such operating procedures to avoid any investment or rebate compliance errors.

5. Expenditures and Assets

The System CFO will coordinate compliance for this area and, in consultation with the University Post-Issuance Compliance Officers, may designate individuals on each/any campus to assist in achieving and maintaining compliance.

6. Allocation of Proceeds

Allocation of bond proceeds to capital projects is an important element in the ongoing compliance effort. The default methodology used for making an allocation of bond proceeds is "specific tracing," meaning the proceeds are deemed to be spent on the expenditures to which they are traceable. The System CFO will prepare, or have prepared, an allocation certificate to memorialize the expenditure of bond proceeds (and other funding sources, if any) on relevant projects. The System CFO reviews and updates fields, as necessary, until the bond proceeds are fully allocated and all projects have been fully funded.

The System typically allocates equity or taxable debt to the portion of a project used for private use (if any exists), to minimize the private use of a bond, as documented in the allocation certificate.

7. Private Use

- a. Definition: Private Use (PU) means the use of bond-financed property in a trade or business by any person or entity other than the System. PU is measured separately for each outstanding bond issue. Any proposed Private Use Projects should be reported to the System CFO, who will consult with outside Bond Counsel.
- b. Definition: Capital Lease is a contract entitling a lessee to the temporary use of an asset and has the economic characteristics of asset ownership for accounting purposes.
- c. Any public-private partnerships, which are bond-financed and which the System is ultimately responsible to pay down debt for, will be considered as part of the System debt capacity and reported to the rating agencies.

d. Examples of Private Use:

- i. Leases of System property to non-System entities;
- ii. Noncompliant management or service contracts;
- iii. Noncompliant sponsored research agreements;
- iv. Naming-rights arrangements with a private user.

***Note: According to IRS regulations, activities are only PU if they are carried out in a tax-exempt, bond-financed space.***

e. Monitoring Private Use:

- i. It is the System's general policy that PU in tax-exempt financed facilities should be avoided. It is also the System's current practice to finance capital projects with a layer of non-tax-exempt debt, including the System funds or taxable debt where PU is expected to occur.
- ii. At the time of tax-exempt bond issuance, the System CFO, with the assistance of the Institution Post-Issuance Compliance Officers, will assess and quantify any potential PU in capital projects and confirm that the equity contributions to the respective projects will be sufficient to cover such PU. The System CFO, in consultation with the Institution Post Issuance Compliance Officers, will establish a process for identifying and tracking existing PU for purposes of calculating, at least annually, the percentage of PU being conducted in bond-financed, per-project, and per-bond issue.
- iii. The Institution Post-Issuance Compliance Officers, in consultation with the System CFO, will each establish a process for their campus to review and approve/reject proposals that would result in PU being carried on in a tax-exempt, bond-financed space. Full information must be gathered prior to such decision-making, including the details and location of the (proposed) activity, the financing structures of the facilities in question, and information about other potential PU in those facilities. PU activity may be approved by the System CFO only if:
  - The capital project has enough equity (i.e., non-tax- exempt debt) to allow the potential PU to be fully allocable to equity;
  - Any allocation of potential PU to equity must not use a majority of equity funding available for that project.

f. Remedial Action:

Each System Institution department using tax-exempt debt is responsible for notifying the University Post-Issuance Compliance Officer, or designee, before there is a change in use of the project or facility financed with tax-exempt debt. In the event that such a change in use may result in excessive PU for a bond issue, the System may avail itself of rules under Treasury Regulation Section 1.141-12, which provides for "remedial action" by redemption or defeasance of nonqualified bonds. Remedial action, when properly taken, preserves the tax exemption of interest on the bonds. Failure to meet remedial action may result in significant penalties which will be borne by the institution or department.

In limited circumstances, remedial action may be taken by applying disposition proceeds to other qualifying capital expenditures.

The System will seek advice of bond counsel if remedial action may be required. To the extent that a potential violation of PU rules arises that cannot be corrected through remedial action, or in the event of a potential arbitrage violation, the System will seek the advice of borrower and/or bond counsel concerning its alternatives, which may include approaching the IRS under the Voluntary Closing Agreement Program (VCAP).

8. This Section G shall be read and interpreted consistent with the existing Post-Issuance Compliance Policy Manual of the System. In the event of a conflict, the provisions of the Post-Issuance Compliance Policy Manual shall control.

(Adopted by the Arkansas State University System Board of Trustees on March 10, 2023, Resolution 23-02.)