Internal Bank Annual Report

BACKGROUND

The Internal Bank Policy requires the University to provide an annual report on the Internal Bank. As this is the first report that is being presented for Committee review, the summary of the background and policies previously approved by the Board is included to provide important context to the report that follows.

Prior to the University separating from the Oregon University System (OUS) in July 2014, the OUS worked with the Oregon Legislature, the State Treasurer, the Department of Justice, financial advisors, bond counsel, and key financial managers to improve the treasury management practices of the OUS via the establishment of an Internal Bank. Pursuant to Senate Bill (SB) 270, OUS policies automatically became Oregon State University (University) policies on July 1, 2014, and the University began implementing its own Internal Bank.

An Internal Bank is an accounting and operating unit designated to hold and invest all University operating cash balances and to manage the university-paid long-term debt portfolio for the University. The purpose of the Internal Bank is to facilitate the long-term financial stability of the University through effective asset/liability management strategies and to optimize the organization's capacity to access the capital markets in the amounts needed at a reasonable price.

The benefits of the Internal Bank, as well as the key policies necessary for its operation, are delineated below.

KEY BENEFITS OF THE INTERNAL BANK

Universities across the country are finding creative ways to improve their treasury function. With declining state revenues appropriated to public colleges and universities, the level of operating assets needed to hedge the volatility in a more tuition-dependent environment has been increasing. Universities are pooling operating assets for investment purposes to decrease the volatility of operating cash flows. With these increasing levels of operating assets and the decreased volatility that accrues through pooling, the opportunities for expanding the investment practices applied to these assets (with an appropriate risk-return profile) have become more attractive.

Additionally, universities are looking at long-term debt management from a portfolio perspective. The traditional approach to long-term debt management, wherein fixed-rate securities are issued and the debt service related to proceeds allocated to specific projects is tied to the underlying debt, is giving way to a portfolio approach to debt management. With the portfolio approach, the terms of long-term debt and the timing of issuance are negotiated more strategically, taking into consideration the current capital markets. True variable-rate debt may be introduced and maintained at an appropriate level to lower the overall cost of capital, and its debt service volatility can be mitigated both through a blended rate and through the volatility of returns on operating assets. The repayment schedule relating to allocations of proceeds can be more flexible (unbound by the underlying debt issuance), based on blended rates and different repayment time frames.

Bringing the pooled approach to managing cash balances and investing operating assets, together with the portfolio approach to managing long-term debt, into the Internal Bank allows tighter asset/liability matching and greater efficiencies in accessing the capital markets, from both the investment and the long-term debt perspectives.

MANAGEMENT AND INVESTMENT OF OPERATING ASSETS

The objectives of a pooled cash and investment management structure are to:

- Pool operating assets to decrease cash flow volatility and better manage liquidity;
- Manage the investment of operating assets from an overall risk basis, rather than a security-type approach;
- Maximize return on operating assets within a prudent risk/return profile; and
- Increase revenues and net assets of the University.

All University cash is pooled and invested with the following objectives:

Safety – Safety of principal is the foremost objective of the investment program. Investments of the University will be undertaken in a manner that seeks to ensure preservation of capital in the portfolio. The University will seek to mitigate credit and interest rate risk.

Liquidity – The investment portfolio of the University will remain sufficiently liquid to enable it to meet its cash flow requirements including payroll, accounts payable and debt service.

Return on Investment – The investment portfolio is designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into consideration the safety and liquidity needs of the portfolio.

MANAGEMENT OF UNIVERSITY-PAID DEBT (Article XI-F(1) and OSU Revenue Bonds)

With the passage of several key legislative changes over the past eight years, including SB 270, the University has the needed flexibility to manage its university-paid debt as a portfolio. The University is authorized to issue fixed-rate and variable-rate debt, enter into interest rate swap agreements, and enter into lines of credit or issue commercial paper (CP) or use its own liquidity to provide interim financing for construction projects. With this flexibility, the University has begun pooling and managing its University-paid debt as a portfolio.

Under the pooled approach, utilizing its own liquidity, lines of credit or CP (if authorized by the Board), the University is able to begin its capital investments on a schedule that is uninhibited by the timing of long-term debt issuances. The University schedules and structures the underlying long-term debt issuance to fund the repayment of interim funding and provide the remainder of the funds needed for capital investments to provide for the lowest cost of capital, utilizing a mix of fixed and floating-rate debt. The University provides the construction funds to each borrowing department via a loan from the Internal Bank at a cost of capital that is established based on the interest costs of the entire portfolio of debt—a blended cost of capital. This effectively de-links the debt payments made by the borrowing department to the Internal Bank from the debt service payments made by the Internal Bank to the bond-holders. The Internal Bank strategically manages the University-paid debt via continuous management of the entire debt portfolio and setting an equitable blended rate for all borrowing departments.

This approach to the management of University-paid debt has the following advantages:

The University will minimize its cost of capital by providing interim financing at lower interest costs during construction by limiting the portion of taxable debt issued and by maintaining a portion of the University's outstanding debt on a floating-rate basis. Due to the financing flexibility and typically low interest cost associated with variable-rate debt, it is desirable to have the flexibility to maintain a portion of the University's aggregate debt on a floating-rate basis.

However, variable-rate debt also introduces volatility to the University's debt service obligations. Therefore, the University will balance the mix of variable and fixed-rate debt according to a target guideline that will be established based on the University's ability to hedge such exposure either through interest earned on its operating cash balances, through reserves maintained for that purpose, or some combination thereof. The actual percentage of variable-rate debt outstanding will fluctuate from time-to-time due in part to financing needs, utilization of lines of credit or CP, and prevailing market interest rates.

Managing Volatility
The University will manage interest rate volatility by establishing a standard "blended cost of capital" charged to the departments by the Internal Bank that is sufficient to cover debt interest costs, fund the administrative costs of the Internal Bank, and build a reserve to hedge interest rate movement.

Providing Greater Flexibility and Clearer Planning Horizons
The University provides greater flexibility and clearer planning horizons to its departments by de-linking the actual debt service payments on outstanding debt from the campus projects that the debt funded. Utilizing internal loans from the Internal Bank to fund their capital investments, campus departments can:

- Better predict their debt service costs at the beginning of a project;
- Take out debt on terms more tailored to their specific project; and
- Repay debt early.

By establishing a blended cost of capital, departments can worry less about the interest rate markets and the timing of bond issuances, focusing instead on the project itself.

Maximizing Allowable Arbitrage Earnings
IRS regulations place certain limits on investment earnings (arbitrage) on tax-exempt bond proceeds and on monies set aside to repay tax-exempt debt (sinking funds). The regulations include timing and accounting structure restrictions/limitations and require that the University repay earnings in excess of the bond interest rates that are disallowed by the regulations. The University will maximize allowable arbitrage earnings by strategically entering the capital markets and through strategic management of any debt sinking funds to help avoid arbitrage rebate.

OPERATION

In order to continue operating the Internal Bank with appropriate controls and risk mitigation processes, there are several policies that were approved by the Board in October 2014. These policies are:

- Internal Bank Policy
- Investment Policy
- Debt Policy

INTERNAL BANK POLICY

The Internal Bank Policy established the Internal Bank and sets forth its purpose and major operating parameters. The policy may be viewed at http://leadership.oregonstate.edu/files/policies/internal_bank_policy.pdf. The following provisions are included:

- *Purpose of the Internal Bank Policy* – Describes the purpose of the Internal Bank and its guiding policy.
- *Management of the Internal Bank* – The University Vice President for Finance and Administration delegates to the University Associate Vice President of Finance and Administration the responsibility to manage the Internal Bank and sets forth his/her roles and responsibilities, including both management responsibilities and reporting requirements.
- *Oversight of the Internal Bank* – The University Provost and Executive Vice President and the University Vice President for Finance and Administration provide oversight over the operations of the Internal Bank.
- *Operations of the Internal Bank*:
    - Establishes the approvals required for certain transactions of the Internal Bank;
    - Lists the funds available for internal lending via the Central Loan Program;
    - Describes the process for establishing and maintaining the Deposit Interest Rate;
    - Describes the process for establishing the Internal Lending Rate; and
    - Provides for the establishment of Internal Bank Reserves.

INVESTMENT POLICY

This policy established the investment guidelines pertaining to the operating assets of the University. The policy may be viewed at http://leadership.oregonstate.edu/files/policies/investment_policy.pdf. The following provisions are included:

- *Purpose of the Investment Policy* – Discusses the basic purpose of the Investment Policy.
- *Scope* – Sets forth the specific types of investments that are covered by the Investment Policy.
- *Prudence* – Describes the standards that guide the investing activities of the University with respect to this investment category.
- *Objectives* – Sets forth the primary objectives of the investing activities of the University with respect to this investment category.
- *Delegation of Authority* – Delineates the delegation of investment management authority from the Oregon State University Board of Trustees (Board) to the University Vice President of Finance and Administration.

- *Oversight of Investment Activity* – The University Provost and Executive Vice President and the University Vice President for Finance and Administration provide oversight over the management of the investment program.
- *Ethics and Conflicts of Interest* – Discusses the responsibilities of and disclosures to be made by the University officers and employees with respect to personal activities and interests that could conflict with their investment management activities.
- *Permitted Investment Instruments* – Sets forth investment limits and lists the various investment instruments available to the University with respect to this investment category.
- *Maximum Maturity* – Provides the maximum investment maturity and portfolio duration limits.
- *Safekeeping and Custody* – Sets forth the custody and safekeeping procedures and requirements.
- *Reporting Requirements* – Describes the frequency and contents of periodic reports to the Board on investment activity and performance.
- *Review of Investment Policy* – Requires biennial review of the Investment Policy by the Board.

DEBT POLICY

The Debt Policy established the guidelines pertaining to the issuance of debt and the management of the debt portfolio. The policy may be viewed at http://leadership.oregonstate.edu/files/policies/debtpolicy.pdf. The following provisions are included:

- *Purpose of the Debt Policy* – Discusses the objectives and goals of the Debt Policy.
- *Bond Programs* – Details the range of bond financing options available to the University for its capital investment financing needs.
- *Scope of the Debt Policy* – Sets forth the specific types of University debt that are covered by the Debt Policy.
- *Capital Investment Funding Prioritization* – References the University's capital planning and financing prioritization process.
- *Debt Management Approval Process* – Describes how debt financing for capital investments is approved.
- *Selection of Finance Consultants and Service Providers* – Delineates the guidelines for the selection and hiring of bond counsel, financial advisors, underwriters, banks, other credit providers, and other service providers.
- *Debt Capacity and Affordability* – Sets forth the procedures and financial indicators to be used to assess debt capacity and affordability.
- *Financing Sources* – Details the various financing structures and funding sources available to the University.
- *Compliance with IRS Regulations* – Summarizes the various IRS regulations regarding the usage of tax-exempt bond proceeds in order to maintain the bonds' tax-exempt status.

- *Debt Portfolio Risk and Opportunity Management* – Discusses debt portfolio risks, the use of derivative products, limitations on variable-rate debt exposure, and the monitoring of refinancing opportunities.
- *Central Loan Program Management* – Summarizes provisions and benefits of the internal loan program.
- *Debt Policy Monitoring and Reporting* – Details the debt policy monitoring and debt capacity and affordability reporting process.

Internal Bank Performance Report for FY2015

BACKGROUND

The performance of investments are reported quarterly to the Board and therefore will not be a focus of this report. This report will focus on the financial status of the Internal Bank as of June 30, 2015, and the activity of its Central Loan Program for the year then ended.

PERFORMANCE REPORT

Assets
Assets totaled $590.6 million, consisting of $87.6 million in cash equivalents, $134.5 million in investments and $368.5 million in loans to university departmental borrowers.

Liabilities
Liabilities totaled $567.5 million consisting of $194.1 million in university departmental deposits, $367.0 million in long-term debt to investors and $6.4 million in accounts payable and accrued liabilities.

Net Position
The ending net position was $23.1 million.

Operations
Net Interest Margin – Interest income from loans and investments totaled $20.7 million, with associated interest expense totaling $17.1 million. The resulting net interest margin was $3.6 million.

Operating Expenses – Operating expenses totaled $548,883. The majority of these expenses were costs associated with the issuance of the General Revenue bonds and for consulting and legal services.

Non-operating Revenues – Non-operating revenues consisted of $42,950 in net unrealized gain/(loss) on investments and $1.6 million from the refinancing of Article XI-F(1) debt (Defeased XI-F(1) Debt).

Change in Net Position – Net Position increased $4.8 million from operations.

Impact from OUS Internal Bank Closing
When the OUS internal bank closed, participating members received their respective portion of the interest reserve that had accrued to the OUS Internal Bank since FY2010. In addition, there was a positive financial impact from establishing the internal bank loans and recording the underlying XI-F(1) debt resulting from the dissolution of the OUS Internal Bank. The total of this financial impact was $18.3 million. Approximately $7.6 million of this total had no impact on cash.

Loans

On July 1, 2014, when the OUS Internal Bank was dissolved, the OSU Internal Bank established loans totaling $317.6 million that were previously held by the OUS internal bank. These loans are funded primarily with XI-F(1) debt that was issued by the State Board of Higher Education.

In March 2015, the Board approved the issuance of General Revenue bonds for financing $56.8 million in various projects including the Learning Innovation Center, Nypro real estate transaction, Space Improvement Program, OSU-Cascades Expansion and OSU-Cascades Long-Range Plan. During FY2015, $48.4 million in Internal Bank loans were issued for these projects. The remainder will be issued as the projects require funding.

In addition, there were four new loans issued using Internal Bank liquidity totaling $6.8 million. These loans are covering the capital project costs that are to be paid from OSU Foundation gifts.

Debt Service

Over the life of current outstanding loans, a total of $642.1 million in loan payments will be received by the Internal Bank and $608.6 million in bond debt service payments will be paid to investors.

The FY2015 financial statements, a schedule of outstanding loans, and graphs showing future loan payments to be received and debt service payments to be paid are presented below:

Oregon State University Internal Bank

Statement of Net Position - Unaudited

As of June 30,	**2015**
ASSETS	
Cash Equivalents	
Total Cash Equivalents	**$87,637,933**
Investments	
Oregon Intermediate-Term Pool	83,085,614
P.U.F. Long-Term Pool	49,799,319
Net Unrealized Gain/(Loss)	1,616,501
Total Investments	**134,501,434**
Loans	
Loans	362,026,006
Premium/(Discounts) on Loans	6,431,882
Total Loans	**368,457,888**
Total Assets	**$590,597,255**
LIABILITIES	
Due to Other Funds	
Deposits	$194,101,440
Total Due to Other Funds	**194,101,440**
Debt	
XI-F(1) Long Term Debt	305,624,708
XI-F(1) Long-Term Accreted Interest	4,256,277
2015 A&B Revenue Bonds Long-Term Debt	51,115,000
2015 A Revenue Bonds Unamortized Premium	6,044,543
Total Debt	**367,040,528**
Other Liabilities	
Accounts Payable and Accrued Liabilities	**6,386,926**
Total Liabilities	**$567,528,894**
NET POSITION	**$23,068,361**

Oregon State University Internal Bank
Statement of Revenues, Expenses & Changes in Net Position - Unaudited

For the year ended June 30,	Budget 2016	**Actual 2015**
INTEREST INCOME		
Interest Income	$19,725,671	$18,504,673
Earnings on Cash Deposits	2,379,773	1,970,789
Investment Earnings	14,002	214,495
Bond Building Fund Interest Income	-	911
2015A Revenue Bond Premium	-	29,787
Total Interest Income	22,119,446	**20,720,654**
INTEREST EXPENSE		
Interest Expense-Bond Debt Service	16,200,272	14,362,755
Net Premium/Discount Expense	480,248	491,173
Interest Paid on Deposits	2,379,773	1,970,789
Interest Expense Investment	106,225	276,723
Total Interest Expense	19,166,518	**17,101,440**
Net Interest Margin	2,952,928	**3,619,214**
OPERATING EXPENSES		
Personnel Services	93,750	0
Legal Services (1)	85,000	80,809
Auditing Services (2)	10,400	10,400
Management Consulting Services (3)	180,000	155,525
Professional Services (4)	317,481	294,410
Pooled University Fund Assessment	60,000	4,375
Conference Registration Fee	2,100	0
Miscellaneous Supplies	2,004	0
Employee Travel	5,900	3,364
Total Operating Expenses	756,635	**548,883**
Net from Operations	2,196,293	**3,070,331**
NON-OPERATING REVENUES		
Net Unrealized Gain/(Loss)	-	42,950
Defeased XI-F(1) Debt	-	1,642,069
Total Net Non-operating Revenues	-	**1,685,019**
Increase in Net Position	2,196,293	**4,755,350**
NET POSITION		
Beginning Balance	23,068,361	-
Impact of establishing the loans and OUS IB closing	-	18,313,010
Ending Balance	$25,264,654	**$23,068,361**

(1) Orrick Herrington & Sutcliffe LLP, Pacific Law Group LLP
(2) CliftonLarsonAllen, LLP
(3) Public Financial Management Inc
(4) Bank of New York, Oregon State Treasury, USSE, Citigroup/Morgan Stanley, Moody's, US Bank, Image Master, Underwriter's Discount, Public Financial Management

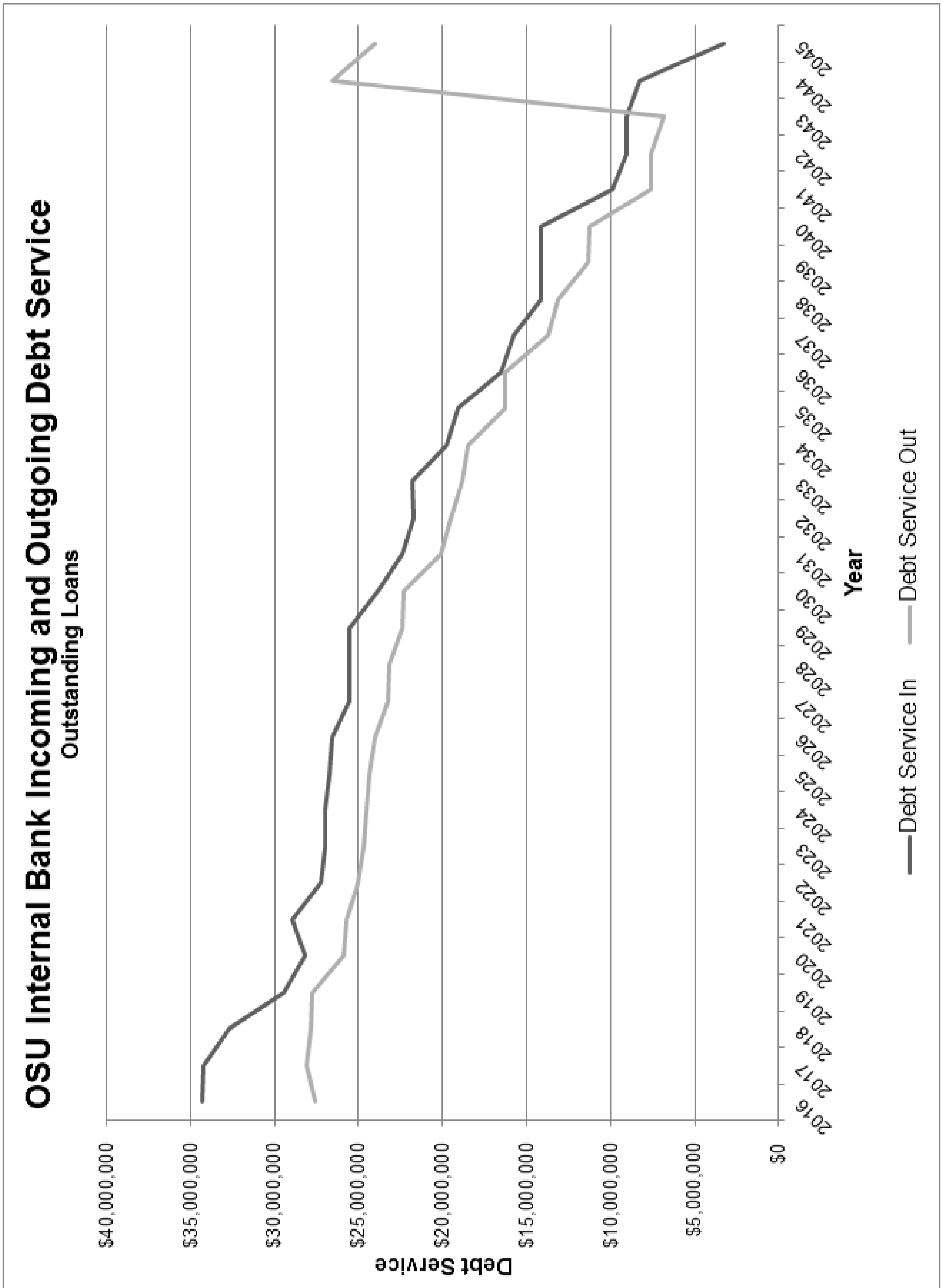
Internal Bank Master List - Outstanding loans

6/30/2015

							Future Cash Flows					
							Totals IN			Totals OUT		
Loan	Issue Date	Payoff Date	IB IN Current Outstanding Balance	Maximum Loan	Normal Amortizing	IB OUT Current Outstanding Balance	Interest In	Principal In	Debt Service In	Interest Out	Principal Out	Debt Service Out
XI-F(1) Total Debt	Multiple	6/30/2044	$302,740,141	N/A	Y	$305,624,708	$229,713,205	$302,740,141	$532,453,345	$196,848,556	$305,624,708	$502,473,264
15A RevBond Classroom Bldg	5/7/2015	3/1/2045	32,500,000	N/A	Y	28,493,912	31,820,952	32,500,000	64,320,952	42,142,592	28,493,912	70,636,504
15A RevBond Nypro	5/7/2015	3/1/2045	5,880,000	N/A	Y	5,155,206	5,754,480	5,880,000	11,634,480	7,624,567	5,155,206	12,779,774
Improvement Program	5/7/2015	3/1/2045	10,000,000	N/A	Y	10,075,000	12,020,539	10,000,000	22,020,539	12,636,670	10,075,000	22,711,670
Austin Hall *	8/1/2014	7/31/2019	3,584,027	$7,000,000	N	N/A	87,975	3,584,027	3,672,002	-	-	-
Goss Stadium *	6/29/2015	5/28/2020	2,059,014	$2,820,000	N	N/A	306,476	2,059,015	2,365,491	-	-	-
Coleman Field *	6/29/2015	5/28/2020	906,924	$1,460,000	N	N/A	88,750	906,924	995,674	-	-	-
Indoor Golf Practice Facility *	6/29/2015	5/28/2020	251,617	$662,184	N	N/A	17,116	251,617	268,733	-	-	-
Weniger Hall**	6/1/2013	6/30/2018	1,736,613	N/A	Y	N/A	82,006	1,736,613	1,818,619	-	-	-
Academic Learning Services **	3/15/2013	6/30/2018	117,707	N/A	Y	N/A	5,557	117,707	123,264	-	-	-
Furman Hall #1 *	6/20/2012	6/30/2017	1,260,000	N/A	N	N/A	69,395	1,260,000	1,329,395	-	-	-
Furman Hall #2 **	6/17/2013	6/30/2018	978,597	N/A	N	N/A	81,983	978,597	1,060,580	-	-	-
Anthropology Equipment**	1/26/2012	12/31/2016	11,367	N/A	Y	N/A	261	11,367	11,628	-	-	-
Total			362,026,007			349,348,825	$280,048,696	$362,026,007	$642,074,703	$259,252,386	$349,348,825	$608,601,211
Revenue Bond proceeds not yet issued to departments			8,430,000			7,390,882						
Grand total			$370,456,007			$356,739,708						

* Loans are to be repaid from foundation gifts	$9,040,179
**Loans are to be paid out of internal operating funds	1,865,687
	$10,905,866

TAB M



OSU Internal Bank Incoming and Outgoing Debt Service
Outstanding Loans
Debt Service
$40,000,000
$35,000,000
$30,000,000
$25,000,000
$20,000,000
$15,000,000
$10,000,000
$5,000,000
$0
2016
2017
2018
2019
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2021
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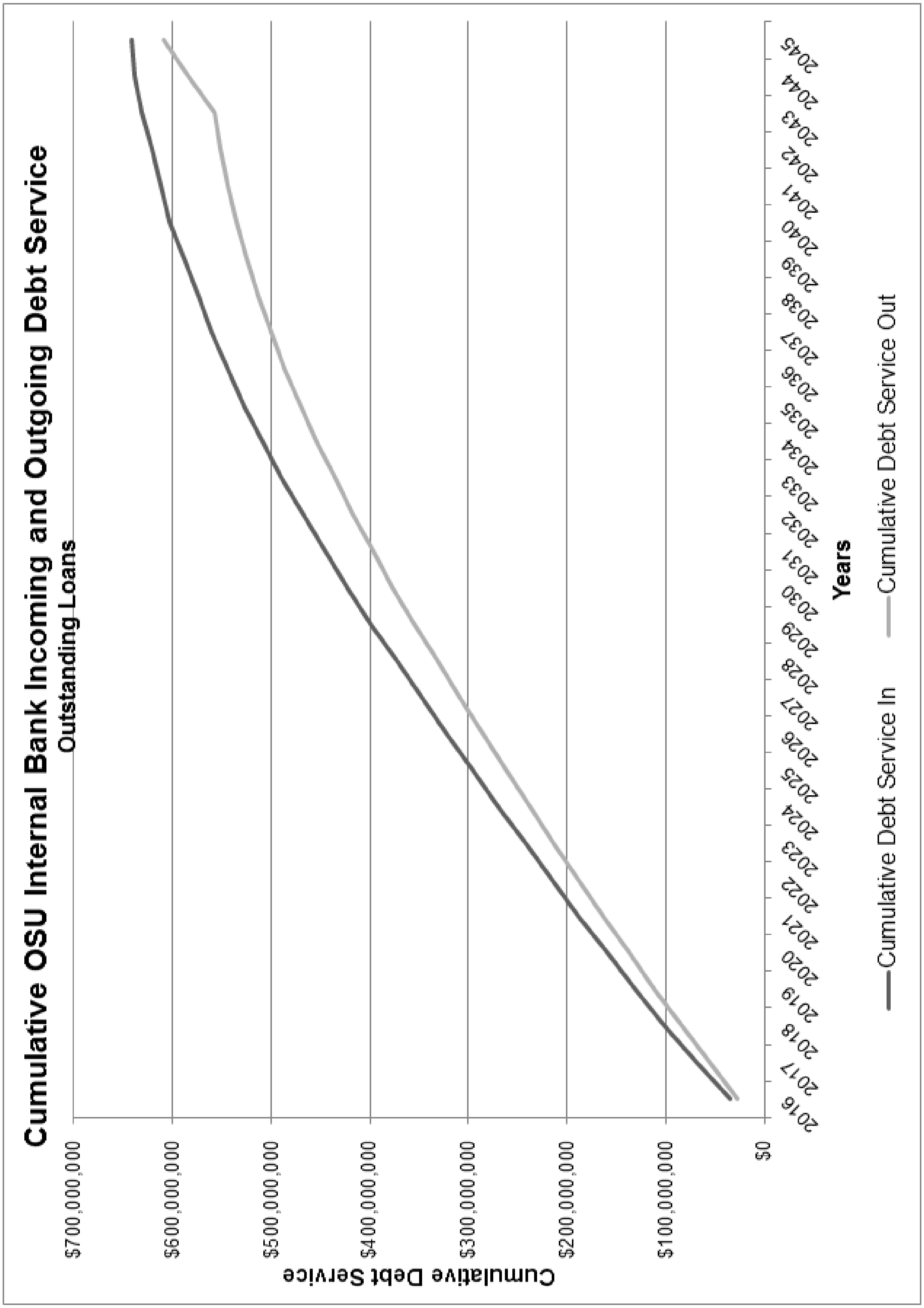
2045
Year
Debt Service In
Debt Service Out



Cumulative OSU Internal Bank Incoming and Outgoing Debt Service
Outstanding Loans
Cumulative Debt Service
$700,000,000
$600,000,000
$500,000,000
$400,000,000
$300,000,000
$200,000,000
$100,000,000
$0
2016
2017
2018
2019
2020
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2041
2042
2043
2044
2045
Years
Cumulative Debt Service In
Cumulative Debt Service Out

TAB M

RECOMMENDATION

Staff proposes that the Committee accept the FY2015 Internal Bank Annual Report.