University of Toronto

OFFICE OF THE VICE-PRESIDENT, BUSINESS AFFAIRS - FINANCE

TO: Business Board

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AGENDA ITEM: **11**

ITEM IDENTIFICATION:
Borrowing Strategy review and recommendations

JURISDICTIONAL INFORMATION:

The Business Board approves the financing of capital projects.

PREVIOUS ACTION TAKEN:

The Business Board approved the Borrowing Strategy on June 17, 2004. Since then, this strategy has been reviewed annually by reports to the Business Board, which have concluded that no change was needed. Regular updates of the borrowing status have been provided to the Board, most recently on December 14, 2009.

HIGHLIGHTS:

The borrowing strategy approved by Business Board in June 2004 included the following key elements:

- Maximum external borrowing capacity equals 40% of net assets averaged over 5 years.
- In the event that outstanding external borrowing exceeds 40% of net assets averaged over 5 years, no further external borrowing will be permitted until such time as the actual outstanding borrowing is not greater than 33% of net assets smoothed over 5 years.
- Maximum internal borrowing capacity equals $200 million of internal funds.
- An internal financing program.
- An internal sinking fund to accumulate funds for repayment of debentures.
- No credit rating parameters.
- No external borrowing debt service or debt repayment requirements.

The borrowing strategy review asked:

- What is the current status?
- How do we compare to others?
- Where are we going? Will this strategy meet our priority needs?
- Should we add credit rating parameters to our strategy?
- Should we add debt service or debt repayment parameters to our strategy?

Current status

This borrowing strategy currently provides for a maximum external plus internal borrowing capacity of $958.4 million at April 30, 2009, of which $942.0 million has been allocated to projects by the Business Board to January 31, 2010. Actual external borrowing at January 31, 2010 was $532.8 million (excluding $2.3 million to be repaid to lenders during 2009-10). Actual internal borrowing at January 31, 2010 was $207.9 million, slightly higher than the $200 million target because internal funds are providing short to medium-term bridge-financing until the University issues the next debenture of up to $200 million.

Benchmarking

We compared the University of Toronto to selected Moody's U.S. Public College and University Medians 2009, with respect to our external borrowing:

+ Actual debt per student of $8,881 was well below medians.
+ Actual debt to total revenue of 29.4% was well below medians.
+ Actual debt service to operations (expense) of 1.8% was below medians.
+ Total resources to long-term debt of 2.83 was similar to medians.
– Unrestricted resources to long-term debt of 0.19 was well below medians.
– Expendable resources to long-term debt of 0.9 was well below medians.
– Unrestricted resources to expenses of 0.06 was well below medians.
– Expendable resources to expenses of 0.26 was well below medians.

To date we have borrowed externally less than our rating peers, but we also have fewer resources to support debt issuance, and we have internal debt, which our peers are likely to have as well.

Projecting maximum borrowing capacity

Net assets increase due to 1) net income (revenues minus expenses) for the year mainly from operating and restricted funds, and 2) growth in endowment, including endowed donations and grants and reinvested investment earnings, offset by 3) the changes in the fair value of interest rate swap contracts. The following table summarizes current projections as compared to last year's projections:

Projected maximum total borrowing capacity ranges (in millions)

	January 2009 Review		January 2010 Review	
	LOW	HIGH	LOW	HIGH
April 30, 2010	983.6	998.0	958.5	958.5
April 30, 2011	987.1	1,014.0	943.6	956.8
April 30, 2012	962.4	1,018.3	907.8	942.1
April 30, 2013	938.2	1,035.2	874.5	944.9
April 30, 2014			886.8	1,009.2

Current projected maximum borrowing capacity is lower than last year's projection, mainly due to lower investment returns on endowments for the fiscal year 2008-09. In addition, divisional and central carry forwards are now estimated to be higher than previously projected.

Reduction in maximum borrowing capacity and availability was projected as follows:

- Net assets are projected to be between $1.8 billion and $2.4 billion by 2014 under current accounting rules, reflecting the long-term operating budget (with no provision for the current pension deficit), ancillary long-term budgets, projections of donations, other receipts, and capital expenditures and under several investment return scenarios.

- Maximum external borrowing capacity is projected to be between $687 million and $809 million by 2014 at 40% of those results averaged over 5 years.
- The continuing use of $200 million of EFIP funds is being confirmed.
- About $122 million in amortizing loan (bank loans, EFIP) repayments and adjustments is expected to be available for reallocation by 2014.

Assuming these projections are reasonable, we would expect between $0.9 billion and $1.0 billion available borrowing by 2014 under current accounting rules. With the $122 million repayment, this will provide about $67 million to $189 million more than the $942 million allocated to January 31, 2009 by the Business Board. Please note that for every 1% change in the 2010 investment return, the maximum borrowing capacity will change by $6 million by 2014.

In addition, apart from the uncertainties contained in the assumptions used to project net assets, there is a risk that the accounting rules, particularly with respect to unfunded employee future benefits, could change in future, negatively affecting net assets.

Credit ratings

The purpose of credit ratings is to give investors an assessment of a borrower's ability to repay debt.

U of T credit ratings are Aal (Moody's), AA (S&P) and AA (DBRS). U of T has ratings higher than those of most of our peers.

Credit ratings are refreshed at least annually by the rating agencies, and may be changed at any time for many reasons including student demand, government policy and funding, debt per student, levels of unrestricted resources, investment performance and quality of management.

Since credit ratings reflect financial health, levels of borrowing and the other factors noted above, no minimum credit rating parameters are considered necessary, and no change in strategy is recommended.

Debt service and debt repayment

How much do we want to spend ON the classroom and other facilities rather than IN the classroom? The following constraints guide our ability to service and repay debt:

- Interest rates are FIXED.
- Allocation of borrowing to any particular project continues to be dependent on the ability of that particular project or division to service the debt and repay the borrowing with low risk of default.
- The internal financing program requires regular principal and interest payments at specified interest rates that are linked to market rates.
- The long-term borrowing pool, an internal sinking fund, accumulates funds for repayment of debentures at maturity.

At April 30, 2009, interest expense as a percent of operations, as defined by Moody's, was 1.8%, well below Moody's medians. Interest expense was 1.8% of total revenues, allocated as follows: 1.1% of operating fund revenues and 12.4% of ancillary revenues.

To January 31, 2010 actual and projected interest plus principal repayments on allocated borrowing of $942 million were $77.6 million annually and represented 3.8% ($51.7 million) of the 2009 operating revenues and 17.9% ($25.9 million) of the 2009 ancillary revenues.

The debt service ratios are well below Moody's medians. Debt service and debt repayment load on a particular division or project is subject to the internal financial parameters outlined above. Therefore, no overall debt service or debt repayment parameters are considered necessary and no change to the current strategy is recommended. Continued careful review of each new project is important to the continued prudence of this approach.

Overall Conclusion

The current borrowing strategy, as approved by the Business Board in June 2004, has the following key features:

- Ability to pay is assessed on a project by project basis.
- A comprehensive and disciplined internal financing program requires regular principal and interest payments for each project at fixed interest rates linked to market rates.
- An internal sinking fund to accumulate the principal repayments collected through the internal financing program to repay the debentures.
- Interest rates are fixed. Debt service and repayment allocations are a reasonable proportion of total revenues and expenses.
- The discipline that this strategy represents has been well received by the lending community based on our selected enquiries.

In conclusion, the current borrowing strategy, as approved by the Business Board on June 17, 2004, continues to be prudent. However, if the actual investment performance falls within the lower range modeled here, it would constrain the University's ability to build and renovate using borrowed funds for the next several years (under current accounting rules) because the University could be in a situation where the actual external borrowing is above 40% of net assets averaged over 5 years. In this event, no further external borrowing would be permitted under the current policy until such time as the actual external borrowing is not greater than 33% of net assets averaged over 5 years.

Additionally, based on current regulatory rules, the University would expect to increase pension contribution requirements beginning 2011. While the actual amount of these obligations will depend upon regulatory requirements at the time and investment earnings in the interim, these contributions could potentially reduce the University's net assets and affect borrowing capacity.

Therefore, in conclusion, the results of this study, along with these uncertainties suggest a cautious approach to new borrowing allocations in the next several years.

We will continue to update the maximum external borrowing capacity annually in June, once the net assets for the year are finalized, and will report it to the Business Board at that time.

FINANCIAL AND/OR PLANNING IMPLICATIONS: Enables a continuation of capital investment on key priorities.

RECOMMENDATION:

For information.