



# Overview of Debt Financing Policies

Office of the Treasury

# Debt Financing Policies



- Types of Projects That May Be Debt Financed
- Responsibility for Providing Debt Financing
- Types of Debt Available to Finance Projects
- Loan Structure and Charges
- CIP Interest Policies

# Types of Projects That May Be Debt Financed



- Generally, any project that is capitalizable may be debt financed.
- Capitalization criteria are determined in accordance with GAAP.
- Facilities and equipment are eligible for debt financing.

# Responsibility for Providing Debt Financing



- At Harvard, debt is raised and provided to all schools and units through the Central Bank.
- Subject to compliance with relevant tax rules, the Bank uses tax-exempt debt to finance capital projects. The Bank can also use taxable debt or its own capital.
- Treasury directs the process of issuing debt externally in the capital markets and makes Bank capital available.
- The form of debt financing for each project is typically decided through discussion between the school or unit and Treasury while the project is being developed.

# Types of Debt Available: Tax-Exempt Debt



- The tax-exempt market provides the least expensive capital funding because the interest paid by the University to its bondholders is exempt from federal and Massachusetts state taxes. As a result, bondholders demand lower interest rates than for bonds that are subject to taxation.
- Federal tax law places important restrictions on the use of tax-exempt debt and the projects financed by such debt. The University, and in particular Treasury and the university-wide Debt Compliance Assurance Group, are committed to maintaining compliance with the rules relating to tax-exempt debt.

# Tax-Exempt Debt- *Private Use Restrictions*



- Federal tax law typically prohibits more than 3% of the proceeds of a bond issue from being used for “private business use.”
- Examples of private business use include:
  - A lease of bond-financed space to a for-profit user.
  - A for-profit entity providing management or other services with respect to bond-financed space, unless certain requirements relating to the contract term and compensation are satisfied.
  - A commercially sponsored research contract performed in bond-financed lab space, unless certain requirements relating to the nature of research and transfer of technology are satisfied.
  - An “unrelated trade or business” conducted by Harvard in bond-financed space.

# Tax-Exempt Debt- *Record Retention*



- To substantiate compliance with the private use, arbitrage and other tax rules, the IRS currently requires that documentation of certain items, including the following, be maintained during the term of the bonds (or combined term, in the case of a refinancing) and for 3 years thereafter:
  - Bond transcript
  - Expenditures of bond proceeds.
  - Ongoing uses of the projects by the borrower or other users (e.g., management contracts and leases).
  - Sources of payment or security for the bonds.
  - Investments of bond proceeds.
- The University's policy is to comply fully with the IRS's record retention rules. Treasury will maintain records of a centralized nature, such as the bond transcript, requisitions and records of investments. Schools and units must maintain records of the current and prior uses of all property financed with tax-exempt debt.

# Tax-Exempt Debt- *Regulatory Requirements*



- In order for the University to issue tax-exempt bonds, federal law requires that the bonds be issued through a state agency.
- The University issues tax-exempt debt through the Massachusetts Health and Educational Facilities Authority (MHEFA) or the Massachusetts Development Finance Agency (MassDevelopment).
- Issuance through a state agency subjects projects financed by the University's tax-exempt debt to certain regulatory review.
- The two most significant forms of review are MHC and MEPA review.  
(See Appendices A and B for detail.)
- If the University does not receive approval or decides not to put affected projects through these review processes, it cannot finance the projects with this source of funds.

# Types of Debt Available: Taxable Debt



- The University is also able to access the taxable debt market, and did so extensively while a cap on tax-exempt issuance was in place from 1986-1997.
- Projects financed by taxable debt must be capitalizable under Harvard policies, but face few other restrictions.
- Taxable debt may be appropriate when a project is for a use that is ineligible for tax-exempt financing under federal or state law.

# Types of Debt Available: Internal Loans



- Internal loans (formerly known as "Treasurer's Advances") represent lending by the Bank from the University's internal sources of capital.
- Loans from this source are restricted to capitalizable projects.
- Loans from this source are only appropriate in limited circumstances.

# Debt Rates



## Blended Debt Rate

- General University use projects
- Rate is the weighted average rate of portfolio of project debt plus approx. 25 basis points in a buffer and administrative costs
- Rate can be reset as frequently as annually

## Short-Term Construction

### Period Rate

- Available for projects with at least \$10 million in debt
- Variable during CIP period
- When projects close, loans carry the blended debt rate

# Blended Debt Rate- Background



- BDR applies to debt-financed capital projects during construction and after completion, when long-term loans are created
- Exceptions are for large debt-financed projects that qualify for the tax-exempt CP program during construction and debt for non-University uses (Arsenal, Allston)
- No prepayment penalty is assessed, which provides flexibility to restructure debt and optimize financial position

# Blended Debt Rate – History



Since inception, the Debt/Asset Management Committee (DAMC) has set the BDR 7 times, as follows:

FY 2002	6.30%
FY 2003	5.75%
FY 2004	5.60%
FY 2005	5.60%
FY 2006	5.55%
FY 2007	5.50%
FY 2008	5.50%

The rate is set for the upcoming fiscal year based on rate performance in the last completed calendar year.



# Blended Debt Rate- Components

The BDR consists of 3 components:

1. Interest cost of external debt
2. Stabilization rate
3. Premium for administrative costs

# Blended Debt Rate- Rate for FY 2008



**The FY 2008 rate of 5.50% consists of:**

1. Interest cost of external debt: 5.31%
2. Stabilization rate: 0.10%
3. Premium for administrative costs: 0.09%

# Short-Term Construction Period Rate



- Specifically, Series EE tax-exempt commercial paper
- Rate is reset each month
- Rate is based on rates set by CP dealer
- Treasury recommends budgeting at 3.5%

# Loan Structure and Charges



- Loans are provided with maturities of varying terms.
- The loan term must be no greater than the useful life of the asset being financed.
- Treasury charges for loans based on coding supplied by the borrowing school or unit.
- Debt service on most loans is currently charged once each year.
- All projects are charged the same blended debt rate regardless of the loan term.

# CIP Interest Policies



- Underfunded CIP projects will be charged the blended debt rate, regardless of funding source.
- For FY 2008, all overfunded CIP balances will be credited 5.1%.

# Appendix A:

## Tax-Exempt Debt-

### *Massachusetts Historic Commission (MHC) Review*



- MHC review is required for any project that results in an exterior change to a building and for which tax-exempt bond funding is sought.
- MHC review is not required if the entire project is limited to interior renovations or repair, unless the building interior is historically significant and listed on the State Register of Historic Places.
- Ordinarily, MHC review will occur during project development, prior to issuance of a building permit.
- In any event, MHC review must occur before a project is eligible for reimbursement from bonds.
- This review requires a detailed filing and 30-day review of the project's impact on historic resources of the project itself and in the surrounding neighborhood.



# Appendix B:

## Tax-Exempt Debt-

### *Massachusetts Environmental Policy Act (MEPA) Review*

- Review of a project under this state law is required only when the project triggers significant environmental thresholds.
- MEPA review is likely to be required only for construction of a large new facility.