

Policy Title:	Interest Rate Risk Management
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Governing Body:	Southern Oregon University	Policy Number:	FAD.054
Policy Contact:	Vice President for Finance & Administration	Date Revised:	July 2016
Custodial Office:	Finance & Administration	Date Approved:	July 2016
Approved By:	President	Next Review:	July 2019
Related Policy:			

Revision History

Revision Number:	Change:	Date:
-	Initial version	July 2015
1	Revision	July 2016

A. Purpose

This policy codifies and revises as Southern Oregon University Policy the rule previously adopted by the State Board of Higher Education concerning this topic and transferred to SOU by operation of law on July 1, 2015.

B. Policy Statement

1. Overview

Southern Oregon University (SOU) maintains a Debt Policy which sets forth guidelines on the authorization and management of debt. The university manages its debt issued under Article XI-F(1) of the Oregon Constitution (XI-F debt) on a consolidated, portfolio basis and makes debt management decisions to achieve the lowest cost of debt capital and maximize its portfolio objectives. The nature of managing debt as a portfolio implies that there may be a mismatch of the specific terms on either side of the balance sheet. These mismatches may include maturity, payment schedule, interest rate, etc. These mismatches cause interest rate risk that may affect cash flow or the value of the underlying debt and corresponding loan. The use of derivatives can play a key role in managing the interest rate risk associated with the university’s debt portfolio and other managed portfolios.

In certain circumstances, derivatives are an effective way for the university to adjust its mix of fixed- and floating-rate debt and manage interest rate exposures. Derivatives may also be an effective way to manage liquidity risks. The university’s philosophy is to use derivatives strategically to achieve asset and liability portfolio objectives and hedge existing exposures. Derivatives will not be used to create leverage or to speculate on the movement of interest rates.

2. Scope

The Interest Rate Risk Management Policy applies to any derivatives used for the purpose of hedging interest rate exposures. This policy does not apply to derivatives used by the State Treasurer's office in its management of any university endowment and assets of any university-related foundations. Additionally, any decisions made regarding the use of derivatives must take into consideration the resulting impact under the university's Debt Policy.

3. Objectives

This policy is intended to: outline the university's philosophy on derivatives; provide guidelines on the use of derivatives; identify approved derivative instruments; and establish a control framework related to the use of derivatives.

The university views derivatives as a tool to achieve its asset and liability management objectives. As a result, it is the university's philosophy to use derivatives strategically in support of this cause. It is also the university's philosophy to not use derivatives to create leverage or speculate on interest rate movements. The university recognizes that the prudent and selective use of derivatives may help it to lower its cost of debt capital and manage its interest rate exposure.

This policy provides guidelines on the use of derivatives including the circumstances under which they may be used and the factors that are considered in deciding whether to use them. Derivatives may be used to achieve the following objectives:

- (i) Reduce the cost for debt financing when compared to conventional debt structures
- (ii) Manage interest rate volatility
- (iii) Manage fixed- and variable-rate debt mix
- (iv) Help match the cash flows from assets with those from liabilities
- (v) Hedge future debt issues or synthetically advance refund bonds.

The policy also outlines a control framework to ensure that an appropriate discipline is in place regarding the use of derivatives. Controls exist to address both operational risks and exposure risks.

4. Oversight

The Vice President for Finance and Administration is responsible for coordination with Oregon State Treasury in implementing this policy and for all interest rate risk management activities of the university. The policy and any subsequent, material changes to the policy are to be approved by the Board's Finance and Administration Committee.

The Vice President for Finance and Administration provides oversight and monitors all derivative transactions.

5. Derivative Use Guidelines

The university may use derivatives to achieve a lower cost of debt funding, manage its exposure to interest rate volatility, and/or match the timing and nature of cash flows associated with its assets and liabilities. The university may accomplish this by hedging the interest rate volatility of projected debt issuances or by using derivatives to adjust its exposure to variable interest rates.

To determine its portfolio exposure, the university looks at the composition of its outstanding assets and liabilities (adjusted for any hedges) and the change in this composition over a predetermined planning horizon. Taking into

account the potential for future uncertainty, the university determines what, if any, action should be taken to keep its portfolio exposures at desirable levels over this period.

In determining when to hedge, the university monitors its interest rate exposure, the capital markets, and its future funding and liquidity requirements. Special attention is paid to the relative level of interest rates, the shape of the yield curve, and signals of interest rate increases or decreases from the Federal Reserve.

The university analyzes and quantifies the cost/benefit of any derivative instrument relative to achieving desirable long-term capital structure objectives. Before entering into a derivative, the university evaluates its risks including, but not limited to: tax risk, interest rate risk, liquidity risk, credit risk, basis risk, rollover risk, termination risk, counterparty risk, and amortization risk.

When evaluating its hedging options, the university generally prefers the lowest cost, most liquid, and most flexible hedging strategy available. In instances where no one hedging strategy meets all these needs, the university prioritizes these requirements to decide on an optimal strategy.

At their inception, derivatives are chosen to closely match the exposures being hedged. As time passes, the university's debt management objectives may change and any decisions will be made with the best information available at that time regardless of hedges that may be in place. For instance, the university may use derivatives to hedge future interest rates associated with a fixed-rate bond issuance. If at the time of issuance it is deemed more beneficial to issue floating-rate bonds, then the university will not let its past hedging decisions constrain its current bond issuance decisions.

In addition, management discloses the impact of all derivatives on the university's financial statements per GASB requirements and includes their effects in calculating the financial ratios identified in the university's Debt Policy.

The Board's Finance Committee will set acceptable risk tolerances for each portfolio, which will determine whether adequate hedging has occurred.

6. Allowable Derivative Instruments

The university recognizes that there are numerous derivatives of varying degrees of complexity. The university attempts to avoid structural complexity in its use of derivatives and believes the following instruments, used alone or in combination with each other, allow for sufficient flexibility to help the university meet its interest rate risk management objectives.

Interest Rate Swaps - Swaps are contracts to exchange payments based on different interest rate indices, generally with one such index based on interest rates that are fixed at a specific rate for the term of the contract and the other based on interest rates that are to be adjusted from time to time throughout the term of the contract. The university may utilize these contracts to change its mix of fixed rates and floating rates to achieve optimal asset-liability balance. They may also be used as a means to hedge future variable rate financings.

Interest Rate Call or Put Options - An option gives the holder a right, but not an obligation, to buy or sell a security at or by a specified date(s) at an agreed upon price in exchange for the payment of a premium. Interest rate options, typically in the form of interest rate caps and/or floors, are designed to provide protection against interest rates being above a certain cap rate or below a certain floor rate. Options may be used when the purchaser faces an asymmetrical risk profile, for instance, the risk that interest rates may rise prior to a new debt issuance. Options to enter into swaps,

or swaptions, give the buyer the right to enter into a swap as a fixed-rate or floating-rate payer depending on the buyer's interest rate exposure.

The university will not sell options, except to the extent they are sold to better hedge an underlying exposure that contains an offsetting option position. For example, a bond with a call option held by the university may be hedged better by entering into a derivative with an offsetting sold call option.

Interest Rate Locks - A rate lock is a forward contract that represents a sale of a specific benchmark security (e.g., U.S. Treasuries, LIBOR, or tax-exempt indices) or other appropriate benchmark security at an agreed price or interest rate. The university may utilize these contracts to help lock in a future financing rate.

Before entering into any derivative transaction, the university first gains a full understanding of the transaction and performs appropriate due diligence, such as (i) a quantification of potential risks and benefits and (ii) an analysis of the impact on the university's debt portfolio. The duration of each derivative may be different from the duration of the risk being offset.

7. Policy Controls

The university has established both operating and exposure controls to address program risks.

A. Operating Controls

When utilizing derivatives, it is important for operating controls to be in place to provide for adequate segregation of duties and management oversight. The university has controls addressing trade initiation, approval, confirmation, and accounting.

Appendix A to this Policy lists the individuals who may enter into derivatives on behalf of the university. These individuals may not approve their own transactions, unless explicitly stated in Appendix A. Initiators may not confirm transactions with counterparties and may not enter the accounting related to a trade. These controls are in place to assure trades are fully disclosed, accounted for, and approved by appropriate parties.

Appendix A also contains a list of individuals with authority to approve transactions. In all instances, unless provided for in Appendix A, an approver may not also be the initiator for a specific transaction.

Confirmations serve the purpose of confirming the details of a trade as understood by the university and its counterparty. Trade confirmations are done by an individual who does not have authority to either initiate or approve transactions.

Transactions are recorded for accounting purposes by an individual who is neither the initiator nor the approver. This segregation helps to assure that trades are accounted for correctly and are recorded and valued correctly on an ongoing basis.

B. Exposure Controls

The university manages its derivatives exposure by looking at its derivatives portfolio independently and also in the context of its overall asset and liability portfolios. Prior to entering into a derivative transaction, the university will examine the impact of such trade independently and on the asset and liability portfolios as a whole. The university will also coordinate this review with the financial advisor contracted by the State Treasurer pursuant ORS 286A.132(a).

All derivatives will be monitored by the State Treasurer's financial advisor to provide valuations of the derivatives and monitor compliance with the terms and conditions of the derivative contract.

Appendix B to the policy establishes limits related to counterparty credit ratings, and the maximum allowable percentage of floating rate debt.

Exposure controls are in place to limit the university's exposure to the various market risks associated with derivatives.

Appendix A - Operating Controls

Authorized Initiators - The individuals holding the following positions are hereby authorized to initiate interest rate derivative transactions on behalf of the university: President, Vice President for Finance and Administration and Director of Treasury Operations.

Approval - All interest rate derivative transactions on behalf of the university must be approved by both the Board's Finance and Administration Committee and the Director of Debt Management, Oregon State Treasury.

Appendix B - Exposure Controls

Maximum Percentage of Floating Rate Debt - The university's outstanding debt portfolio will have no more than 20 percent of the principal amount in floating rate debt, as described in its Debt Policy. This percentage is calculated to factor in the effects of interest rate derivatives.

Counterparty Credit Exposure - All derivative counterparties will be rated A3 or better by Moody's and A- or better by Standard & Poors. The maximum allowable credit exposure, determined by the net mark-to-market of all trades with a single counterparty, will be \$25 million for counterparties rated Aa2/AA or better and \$10 million for counterparties rated less than Aa2/AA.

The university may takes steps to reduce its exposure to a counterparty by either (i) requiring the counterparty to post collateral in the full amount of the exposure (all the while abiding by the terms of any Credit Support Annex between the university and the counterparty), (ii) terminating all or a portion of its outstanding contract(s) with the counterparty, or (iii) requiring the counterparty to obtain swap insurance or provide another form of third-party security agreeable to the university.

The university will also strive to limit counterparty exposure to no more than \$100 million per notional amount with the strategy of diversifying the use of counterparties. In determining counterparty credit exposure, the university will also consider the counterparty's credit exposure to other university-related organizations (e.g., the SOU Foundation).

Measuring Exposure - The internal bank will compute the overall interest rate risk exposure faced by the internal bank within 90 days after each debt issuance and no less frequently than once per year. The internal bank may use its own computational models to compute this risk or contract with a third party to supply this information.

This policy may be revised at any time without notice. All revisions supersede prior policy and are effective immediately upon approval.

C. Policy Consultation

This policy was transferred to SOU by operation of law on July 1, 2015 from the State Board of Higher Education Board Policy Manual. Revisions to the text of the policy were posted for campus comment on June 21, 2016.

D. Other Information

The Policy Contact, defined above, will write and maintain the procedures related to this policy and these procedures will be made available within the Custodial Office.