Interest Rate Swap Policy
July 16, 2004

Introduction

The purpose of the UW Debt Management Interest Rate Swap Policy ("Swap Policy") is to establish guidelines for the execution and management of the UW interest rate swap program. This amendment to the UW Debt Management guidelines to incorporate this Swap Policy confirms the commitment of the Board, management, staff, advisors, and other decision makers to adhere to sound financial and risk management practices, including achieving the lowest possible cost of capital within prudent risk parameters.

Philosophy Regarding Use of Swaps

Interest rate swaps can be appropriate interest rate management tools. Properly used, swaps can increase the University's financial flexibility, provide opportunities for interest rate savings, or reduce financial risk. Swaps will be integrated into the University's overall debt management.

Interest Rate Swaps, and the related instruments detailed below, are used to accomplish the following:

- Reduce interest expense;
- Hedge and actively manage interest rate, tax, basis, and other risks;
- Optimize capital structure (e.g., achieve targeted debt allocation); and
- Achieve appropriate asset/liability match.

Permitted Instruments

The University may expressly use the following financial products after identifying the specific financial objective to be realized and assessing the attendant risks:

- Interest Rate Swaps -- Immediate or forward starting floating-to-fixed rate swaps, designed to capture current market fixed interest rates or eliminate variable rate exposure. Fixed-to-floating rate swaps, designed to create additional variable interest rate exposure.
- Interest Rate Caps -- Financial contracts (caps, collars, floors) which limit or bound exposure to interest rate volatility.
- Options on Swaps –- Sales or purchases of options to commence or cancel interest rate swaps.
- Basis Swaps -- Floating-to-floating rate swaps to manage basis or tax risk and change the basis on which variable cash flows are determined.
- Rate Locks –- Often based on interest rate swaps, used to hedge an upcoming fixed rate bond issue.

The use of derivative financial products should produce a result not otherwise available in the debt market (lack of advance refunding/non-callable debt) or provide a higher level of savings, lower level of risk, greater flexibility, or other direct benefits.

The University may not use financial instruments that (i) create excessive leverage or financial risk; (ii) lack adequate liquidity to terminate at market; or (iii) provide insufficient price transparency to allow reasonable valuation.

Swap Risk Analysis

The University will evaluate all financial products with respect to the unique risks with which they are associated. A specific determination must be made that the expected benefits exceed the identified risks by an adequate margin over those available in the traditional debt market, if any.

For each transaction in isolation and in the context of all financial assets and liabilities, the University will perform a risk evaluation of the following factors:

- Market or interest rate risk - Does the transaction hedge or create interest rate volatility? By how much?
- Tax Risk - Is the transaction subject to a future change in federal income tax policy? If so, is the tax risk justified by expected benefits?
- Termination Risk - Under what circumstances might the transaction be terminated? What is the probable range of values? How would a possible termination payment be funded?
- Legal Risk - Is the transaction expressly authorized?
- Counterparty Risk - What is the creditworthiness of the counterparty? Is the transaction subject to future material change in counterparty creditworthiness?
- Rating Agency Risk - Is the proposed transaction consistent with current ratings?
- Basis Risk - Do the anticipated payments the University will receive match the payments it makes? If not, is the basis risk justified by the expected benefits?
- Amortization risk – Does the swap amortize in the same amounts and on the same schedule as the related bonds, and if not, what are the consequences of a mismatch, and how will this be handled?
- Rollover risk – If the swap terminates before the final term of the bonds, what is the range of results that could occur in entering into a new swap, and how will an adverse swap rate change be handled?
- Subsequent Business Conditions - Does the transaction or its benefits depend upon the continuation, or realization, of specific industry business conditions?

All swaps entered into by the University will be in compliance with RCW 39.96.

Swap Procurement and Execution

All services related to derivative financial products, including swaps, will be procured in a manner consistent with the University's standing practices for procuring investment banking and other services, so as to provide the University with the highest level of service at the best available terms and pricing.

The Board of Regents approval is required on all interest rate swaps. In the delegation of authority to undertake swaps the Board may also delegate discretion regarding future termination or modifications of the initial transactions provided the resulting structure is otherwise consistent with the Swap Policy (see Active Management, below).

Prior to execution of a swap or similar transaction, Financial Management Office will work with University accounting staff to ensure that all parties (borrowing department, Financial Management Office) have a clear understanding of the cash flow and reporting treatment of the proposed transaction.

Swap Counterparties Policy

The University shall execute credit-sensitive derivative transactions only with counterparties with strong credit ratings. The University shall do business with counterparties rated in the "AA" category or above as of the transaction date on a non-credit enhanced basis.

For lower-rated (below "AA" category) counterparties, the University shall require credit enhancement in the form of:

- Collateral and/or
- Guarantees

Should the rating of the counterparty be below the "AA" category or the counterparty's rating be downgraded below the "AA" category, if its payment obligations are not guaranteed by another entity, or the entity that guarantees its payment obligations, if so secured, does not satisfy the requirements set forth above:

- The obligations of the Counterparty will be 102% collateralized by cash or Treasuries or Agencies; and
- The cash or obligations will be deposited with the University or with an agent of the University; and
- The collateral obligations will be valued daily.

The University will structure swap agreements to limit losses due to non-performance of its swap counterparties.

The University will establish and review counterparty exposure limits. (Not-to-exceed amounts for a given counterparty).

Swap Documentation

The University will use standard ISDA swap documentation, including the Schedule to the Master Agreement Credit Support Annex, and Confirmation. The University swap documentation will include the following features:

- Key provisions, including those related to early termination and collateral requirements.
- The specified indebtedness related to credit events in the Master Agreement will be narrowly drafted.
- Eligible collateral will be limited to Treasuries, Agencies, and cash.
- Collateral thresholds will be set on a sliding scale based on credit ratings.
- Termination value will be determined by "market quotation" methodology.

- A credit support annex will be used to document swap termination value collateralization procedures.

Active Management

The University will seek to maximize the benefits it accrues and minimize the risks it bears by actively managing its swap program. This will entail continuous monitoring of market conditions, in conjunction with the swap counterparty and the University's advisors, for emergent opportunities and risks. Active management may entail modifications of existing positions including:

- Early termination;
- Shortening or lengthening the term;
- Sale or purchase of options; and
- Application of basis swaps.

Each proposed modification must be consistent with this Swap Policy and be expected to further the goals of the swap program. The Financial Management Office will have limited yet sufficient flexibility to actively manage existing transactions without Board approvals.

Reporting and Disclosure

The Financial Management Office shall provide the Board of Regents with annual reports on the status of its swap and other derivative transactions in conjunction with annual debt management review. These reports will include market values, cash flows, value at risk and other performance measures, as well as evaluations of each transaction's performance relative to benchmarks or goals. The reports will also note all material changes to swap agreements.

The Financial Management Office will report to rating agencies periodically on the status of its swap and derivative transactions in conjunction with periodic updates on bond debt and debt management.

The University shall ensure compliance with the Swap Policy as well as then-current accounting practices and federal, state, and local regulations and requirements.