Possible Scenarios for Self Financing Debt Strategies

Following analysis of the initial draft report from Sector on suitable debt strategies for the take on of HRA Self Financing debt and a follow up meeting with John Whitehouse from Sector, this note outlining the "pros and cons" of the various debt strategies has been produced for the information of the HRA Self Financing Board and to aid them in deciding which strategy should form the "central position" to be recommended to the Executive as part of the HRA Self Financing Business Plan report to be presented to them in January.

The first thing that needs to be said is that there is no right or wrong strategy and whatever debt strategy is finally chosen, it needs to be neutral in terms of its impact on the Council's overall Treasury Management position i.e. there should be no cost to the General Fund. On this basis a two pool approach is favoured whereby all the HRA borrowing is "ring fenced "within its own pool so that all the debt servicing costs of Self Financing falls upon the HRA.

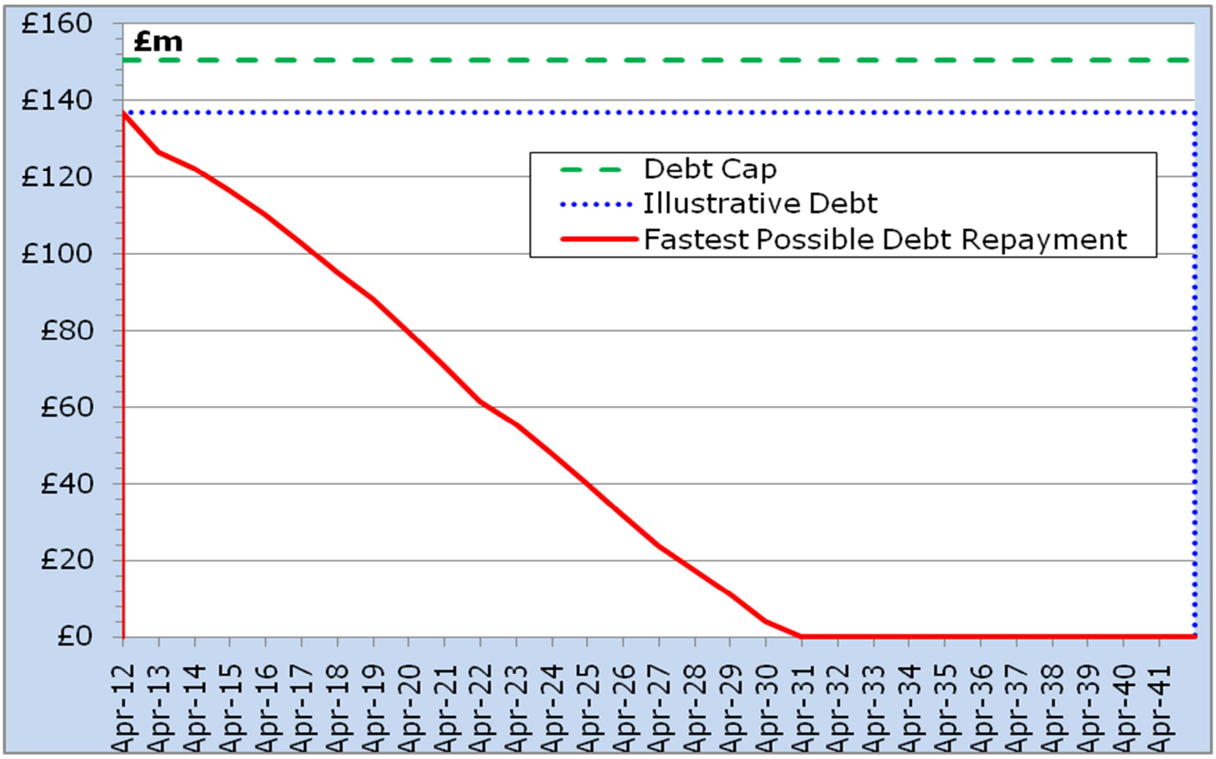
Following the recent announcement of discounted PWLB rates for the self financing debt take on (but not any headroom between the debt settlement and the debt cap which in this case is equal to the subsidy CFR (some £13.8 million) this Council is looking to secure all or substantially all of the approximately £140m debt settlement from the PWLB be it on a fixed or variable interest rate basis or a combination of both. Sector's view is that a maturity loan structure would be better for WDC rather than annuity or EIP (Equal Instalments of Principal) loans as these carry a re-financing risk i.e. higher interest rates when they mature should they need to be replaced rather than fully paid off. However, this does not preclude some "internal" borrowing whereby the General Fund lends some of its balances at a suitable interest rate for a short amount of time in order to produce an investment interest gain for the General Fund and a reduction in borrowing interest for the HRA and this will be discussed further later in this note.

The following paragraphs deal with some suggested debt strategies where the entire self financing debt is borrowed from the PWLB and this is then followed up by a paragraph discussing how internal borrowing from the GF may impact on these strategies.

Debt Strategy 1 – Borrow one 30 year Fixed Interest Maturity Loan

The graph below illustrates this strategy:-

Option 1 – 30 Year Maturity Loan



Advantages

This option gives certainty in that the HRA will have fixed annual interest costs for the life of the business plan. For instance, the interest rate on a 30 year PWLB loan taken out in March 2012 is estimated to be around 3.20% and therefore the annual interest payments on a £136.8m 30 year fixed rate loan would be £4,378,000 throughout the life of the business plan.

This therefore aids future business planning as one significant element of cost is effectively a constant throughout the life of the plan.

In addition, there is no re-financing risk from increased interest rates which may occur with shorter maturity loans should the Business Plan not build up the predicted surpluses required to repay the loans as they mature requiring the Council to go out and re borrow the money required to repay the maturing loans.

The current Business Plan is based on repayment of debt after 20 years and all annual surpluses after allowing for the retention of a £1.25m working balance are diverted to paying off this debt. By taking a 30 year loan and building up the debt repayments on a straight line basis throughout the 30 years it is possible to reduce the amount of annual set aside currently factored into the Business Plan thus producing an additional surplus or buffer against unexpected shocks to the Business Plan in its early years.

Also, the provision for the ultimate repayment of the debt builds up over the years and earns additional investment interest which of course helps the business plan fund increased costs or improved standards of service. It is difficult to predict the path of investment interest rates over the 30 year span of the Business Plan but as an indication of what interest might be earnt on these set aside amounts, the Business Plan predicts that by 2015/16 £19.1m will have been put aside which based on the Council's anticipated investment interest for 2015/16 of 3.44% would result in an income of £657,000 per annum. The amount set aside for debt repayment would of course continue to increase until year 20 which is the point in the Business Plan at which the debt provision could be fully "paid off", although of course this will not happen in practice until year 30, and the ensuing years surpluses would increase by the amount no longer being set aside for debt repayment.

It is likely that as the Business Plan progresses there will be the ability and desire for further investment in the stock or in additional stock that is not allowed for within the current Business Plan. This will in effect utilise the anticipated surpluses that the Business Plan is forecast to accumulate in future years. By not having repaid debt, and having secured debt upfront, the HRA will have the funds to invest. If it had to secure additional borrowing at a future date, this is likely to be at rates in excess of the rates that will be available from the PWLB in March 2012.

There is also an advantage from a fairness point of view in that it has always been the case within capital accounting that the debt associated with long term assets such as council housing should be spread over the expected life of the assets e.g. 80 years. That way, future tenants not just the current ones, also bear a share of the cost of providing the house that they live in. Although obviously not for the full life of the asset, a maturity loan for 30 years would help to achieve this aspect of "fairness".

Disadvantages

The first disadvantage is that fixing a loan for 30 years is not necessarily the cheapest form of borrowing in that taking maturity loans for shorter periods e.g. 10, 15, 20 and 25 years will produce a lower overall interest rate than the 3.20% previously referred to. This will be illustrated further in the third option.

One 30 year loan gives less flexibility than a mix of loans should the Business Plan assumptions not prove to be as robust as expected or need changing due to altered circumstances. For instance it may be necessary to repay debt faster in the earlier years due to unforeseen changes in the Business Plan revenue income & expenditure which makes the servicing of a 30 year loan in later years unsustainable. The repayment of a 30 year loan early in its life is likely to lead to crippling premiums which would have to be paid for out of the Business Plan revenues albeit spread over a number of years whereas repaying or rescheduling shorted maturity loans whilst still incurring premiums would be more manageable as the premiums would be less.

Taking out one 30 year loan at the onset of self financing also means that the HRA will not be able to take out any further long term borrowing other than the headroom between the self financing settlement and the debt cap during the lifetime of the Business Plan. This means that any aspirations such as new build would have to be funded out of the revenue surpluses generated.

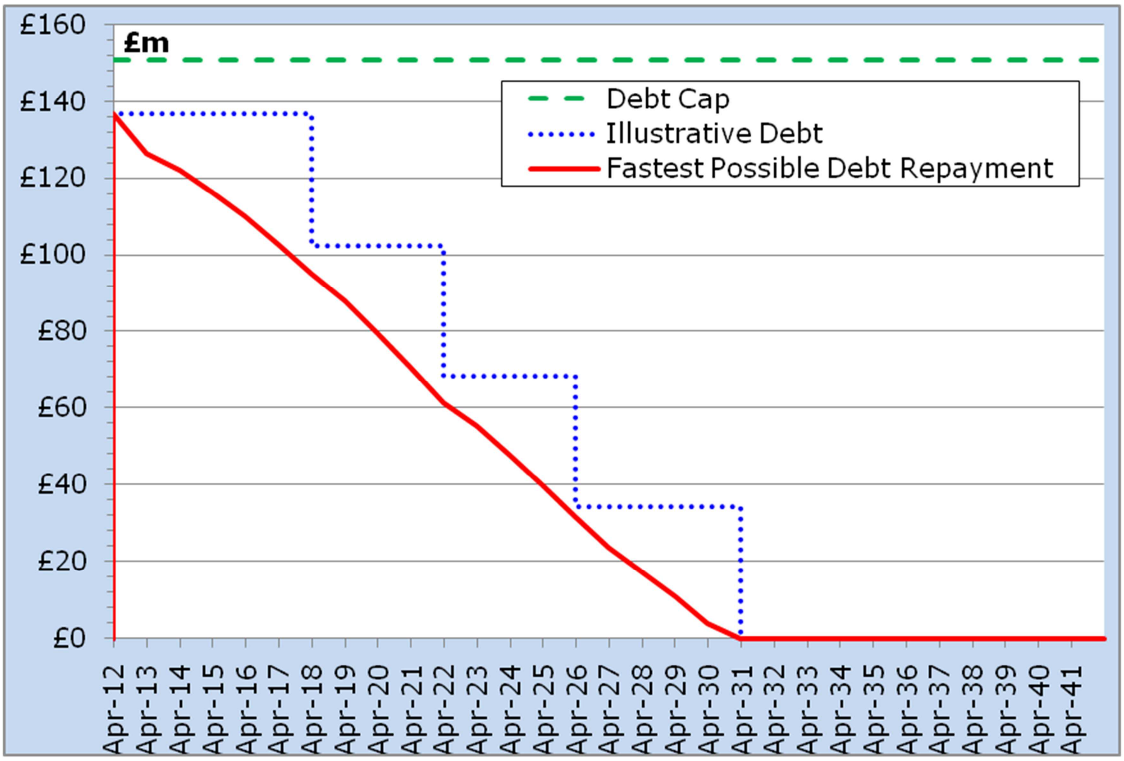
Although unlikely in the current interest rate environment, locking in to a 30 year loan also reduces the ability to take advantage of any dips in long term interest rates during the latter life of the Business Plan in order to reduce the overall borrowing rate of the portfolio.

There is a risk of investment rates for balances built up earning below the borrowing rate.

Debt Strategy 2 – Repay Debt As Quickly As Possible

The graph below illustrates this strategy:-

Option 2 – Several Maturity Loans in Line with Business Plan Forecast Requirements



Advantages

The current Business Plan envisages that the debt settlement can be paid off in full after 20 years and this could be done by either taking one 20 year loan or loans maturing after say 10, 15 and 20 years. Whichever of the two routes chosen, this would lead to a lower overall interest cost than one 30 year fixed loan as referred in Debt Strategy 1.

Accelerated physical repayment of debt would release headroom for new borrowing which could be used to fund aspirations such as new build.

Depending on how much new borrowing was undertaken, surpluses released from debt provision could be used to enhance standards of maintenance etc.

Until spent or used to finance new borrowing the surpluses building up would be earning additional investment interest.

Disadvantages

Accelerated debt repayment puts a massive strain on the assumptions in the Business Plan as it requires the predicted surpluses to be achieved in order to provide the funds required for the physical debt repayment. If those surpluses are not achieved through, for instance, reduced rental income or additional repairs & maintenance then there will be a requirement to re-borrow at higher interest rates which the Business Plan may not be able to afford leading to cuts in funding available for repairs etc. Alternatively, the maturing debt would have to be paid for out of the Business Plan revenues which again would have serious consequences for the maintenance of the stock and given the size of debt repayment required probably would be impossible in any case.

Early debt repayment of debt would reduce the amount of investment interest potential that could be gained from delaying the repayment of debt until later in the Business Plan cycle as referred to in Debt Strategy 1 above particularly if the interest rate curve inverts itself (i.e. long term borrowing rates are lower than investment rates) as has happened before and is indeed the situation illustrated in Debt Strategy 1 where in 2015/16 the investment rate is above the overall borrowing rate.

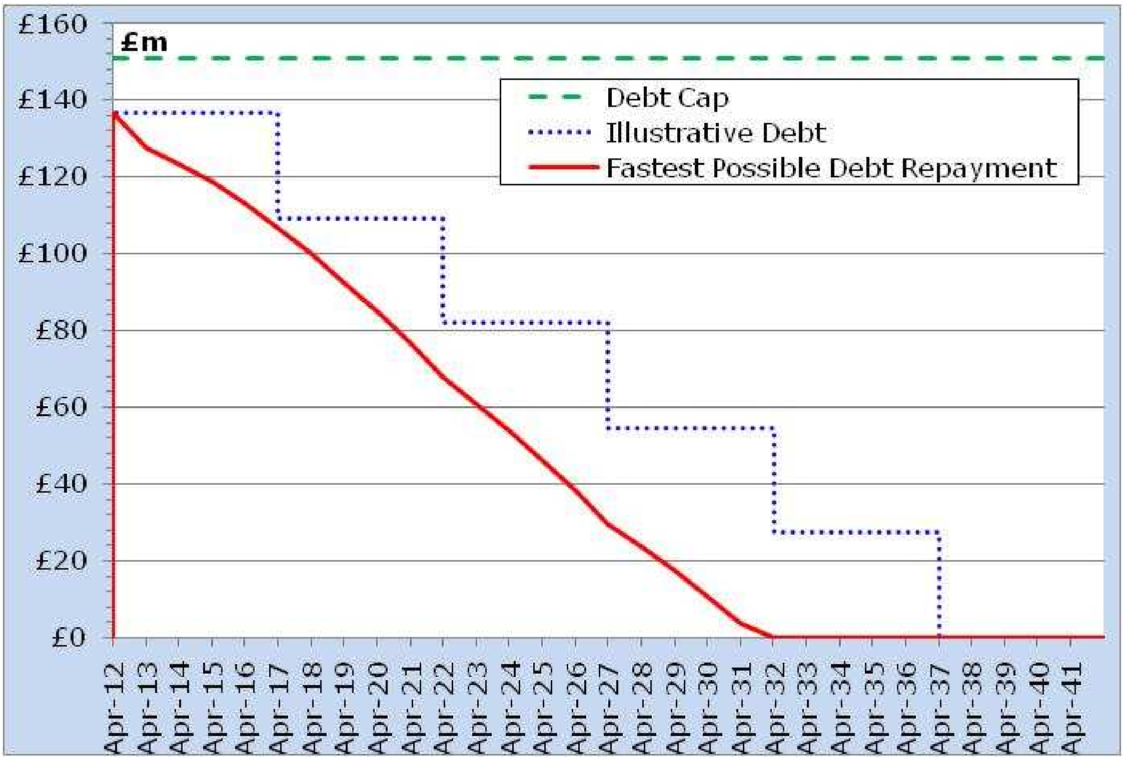
Large surpluses would accumulate (approx. £98m in WDC’s case over the period 2032/33 to 2046/47) and although the Government has said that it will not re-open the debt settlement, there is no guarantee that a future Government would not do so and adjust the debt settlement figure upwards particularly if it sees large surpluses building up in Authorities who have followed the accelerated debt repayment path and there are other authorities who are struggling to make their HRA’s solvent due to the burden imposed by their debt settlement.

This strategy does not fit the “fairness” concept as outlined in Debt Strategy 1.

Debt Strategy 3 – Borrow Maturity Loans with Different Maturities

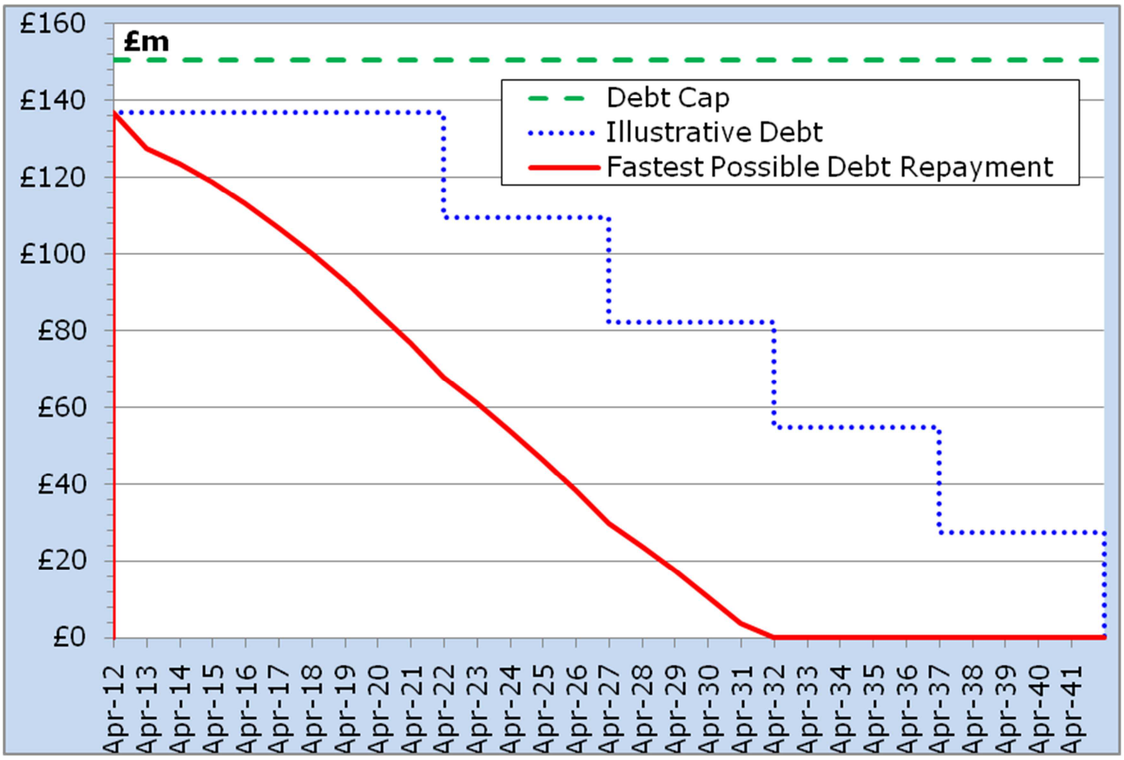
The graph below illustrates this strategy with all debt repaid by year 25:-

Option 3 – Several Maturity Loans over 25 Years



The graph below illustrates this strategy with all debt repaid by year 30:-

Option 3 – Several Maturity Loans over 30 Years



Advantages

This could be said to be the neutral treasury position i.e. "middle of the road" as the maturity profile of the debt is matched to the optimised ability of the Business Plan to fund the debt repayments but with some longer term debt with a maturity longer than the repayment profile forecast from the Business Plan. Debt is taken in suitably sized "chunks" to be repaid after say 5, 10, 15, 20 and 25 years (see 1st graph above) although we could take it in whatever maturity profile that we wish e.g. yearly . This gives the advantage of a lower overall interest rate than one 30 year loan whilst avoiding the potential problems of an overly accelerated debt repayment schedule. For instance, based on anticipated PWLB rates in March 2012, repayment periods as outlined above and the annual debt repayment provision in the current Business Plan the overall borrowing rate could be 2.50% compared with the aforementioned 3.20% for a 30 year loan, a saving of £0.958m per year in interest paid which can be used to bolster the revenue expenditure on the likes of repairs & maintenance. In reality we would probably start repaying after 10 years in order to give the Business Plan time to settle down so based on repayments after 10,15,20,25 and 30 years (see 2nd graph above) the overall borrowing rate could be 2.88% which when compared with the 3.20% for a 30 year loan would produce a saving of £0.438m per year.

Future borrowing is possible based on the debt maturity profile but at potentially higher interest rates.

Borrowing for longer than the 20 years in Debt Strategy 2 relieves some pressure on the Business Plan assumptions and allows for more flexibility should the Business Plan require it in later years. If further investment is planned in future years, the HRA will have already secured loans to finance some of it. Those loans taken out at inception are likely to be at far more favourable rates than may be possible at some future date. With this in mind, it is possible, and may be advantageous to take some debt for in excess of 30 years (possibly 50 years) at the start.

This strategy more closely fits the "fairness" concept as outlined in Debt Strategy 1 than does Debt Strategy 2.

There is less likelihood of the Government re-opening the debt settlement if it can see that the Council still has some debt throughout most if not all the life of the Business Plan.

The Business Plan still benefits from additional investment interest albeit not as much as in Debt Strategy 1

Disadvantages

Like Debt Strategy 2 it relies upon the Business Plan to achieve sufficient surpluses in order to repay the debt when it matures although being staggered throughout the Business Plan the effect of re-financing if required is less than in Debt Strategy 2.

If re-financing occurs it will be at a higher rate than the matured original loan.

Variable Rate Debt

The Council does have the option to use variable rate borrowing rather than fixed rate. Variable rate debt is likely to be the cheapest form of borrowing available from the PWLB initially. Variable debt is usually secured when rates are low with the intention of replacing the debt with fixed loans when fixed rates reduce. This does not reflect the current position, especially as rates will be increased beyond March 2012. However, the announcement by the PWLB that the special rate will only be available on the 26th March may have an impact on the Business Plan's appetite for variable debt and some element of variable rate debt may be advantageous if there is the intention to physically repay debt as soon as the business plan permits.

Internal Borrowing

As already mentioned there is potentially scope for some internal borrowing from the General Fund to part fund the debt settlement and were this to take place it would obviously reduce the amount required from the PWLB under the Debt Strategies outlined above although the various advantages and disadvantages would still remain and has the potential at least in the short term to reduce the interest bill to the HRA thus helping it through the difficult early years.

It is estimated that at 31st March 2012, the Council's cash backed reserves will amount to £23 million of which £13.6m relates to the General Fund and depending on slippage on General Fund revenue and capital programmes this may increase. During 2012/13 these reserves are estimated to earn a return of 1.39% when invested therefore there is an opportunity for the General Fund to earn increased interest by lending the cash backing these reserves to the HRA at a rate higher than the forecast investment return whilst the HRA would benefit by funding part of its self financing debt settlement at a lower rate than it could obtain from the PWLB. However, as ever, there are advantages and disadvantages to this approach. The three key things to be decided at the onset are how much, how long and at what rate?

The how much and how long are dependent on what plans there are for the use of the various reserves over the coming years. It should be noted that it is the cash backing the reserves not the reserves themselves that will have been used to part fund the settlement and this will be achieved by liquidating some of the Council's investments. As previously mentioned there is likely to be a maximum of £13.6m available but it would be prudent to lend the HRA a lower amount than this and the actual amount would need to be calculated by reference to the Council's cash flow forecasts and Medium Term Financial Strategy and therefore at this point in time it is not possible to put a finite figure on how much the GF might lend the HRA.

However, this cash will need to be replenished in due course in order to allow spend from these reserves in accordance with the Council's Medium Term Financial Strategy and this will limit the length of time that this cash can be invested with the HRA. Assuming that the arrangement is for the HRA to repay the internal borrowing to the General Fund and then re-finance this from the open market then it could end up increasing its interest costs as the re-financing is likely to be at a higher interest rate although this could be ameliorated in the short term by the use of variable rate borrowing. If the HRA were not to repay the internal borrowing then it would be the General Fund that would bear the additional borrowing costs required to replenish its cash reserves.

In the early years after Self Financing, the Business Plan will be managed most cautiously. This means that it should be in the position where it is able to reduce the overall level of debt.

With regard to the rate, there are a number of different options available and these include:-

- Using the current CRI calculation within the Housing Subsidy i.e. 3 month LIBID
- PWLB 3 month variable rate averaged out over the year
- The actual investment interest rate achieved by the Council for the year
- A discount off the overall interest rate on the self financing loans taken from the PWLB

Use of any of these rates will provide a saving to the HRA whilst providing the General Fund with a useful amount of additional interest but in the whole scheme of things, internal borrowing can only provide a relatively small amount of the overall self financing debt settlement.

Headroom

The draft determination indicates that the self financing settlement will be £136.832m within a "debt cap" of £150.672m. The difference of £13.840m represents the "headroom" or additional borrowing that the Council can incur during the lifetime of the Business Plan and is effectively the HRA Subsidy Capital Financing Requirement (CFR). This could be used to further invest in our own stock or provide for new build but any borrowing for this headroom will not be at the preferential rates applicable to the self financing settlement nor need it be taken at the outset of the Business Plan but utilised throughout the life of the Business Plan as required. However, depending on what the path for long term borrowing interest rates is expected to be, there may well be a case for borrowing the headroom in advance of need and carrying the cost of this borrowing until needed in order to secure the lowest possible interest rate, this will be discussed further with Sector.

Other Issues

Now that the Localism Bill has received Royal Assent, the Council now has the ability to borrow in advance of need and therefore, in theory, it is possible to take advantage of the current low long term interest rates in the money markets and borrow the self financing settlement in advance of the payment date of 28th March. In reality, this is not likely to happen as any external borrowing will be from the PWLB and it has just announced that the special rates will only be available on the 26th March which is the last day that we can transact on their web site in order to ensure that we will receive the cash on the 28th March to enable us to make the payment to DCLG.

Should long term rates on the 26th March be significantly higher than currently forecast, then this does create some interest rate risk to the rates used in the options outlined above and representations are being made to the PWLB by both Sector and CIPFA saying that this is not good treasury management. Essentially, Councils wishing to borrow from the PWLB are being tied into the "rate on the day" rather than being allowed to make use of variations in long term interest rates between now and the 26th March in order to minimise the interest paid on long term debt by taking the debt early.

Summary

Debt Strategy 1 offers certainty over debt servicing payments but lacks flexibility and there is no prospect of fresh borrowing other than the headroom.

Debt Strategy 2 repays the debt as quickly as possible and allows for fresh borrowing but is the riskiest strategy of the three especially if the Business Plan does not perform to expectations.

Debt Strategy 3 is the "middle of the road " solution and offers the best balance between limiting debt servicing costs and flexibility and is therefore the recommended draft strategy that should be followed when finalising the borrowing.

Naturally, this is an evolving subject and it should be borne in mind that all the scenario's shown above are for illustrative purposes only and may not be what eventually emerges. Once the final determination has been received in January it will be possible to finalise, in conjunction with Sector, the debt strategy including any internal borrowing and feed this into the Business Plan.

Finance
03 December 2016