Borrowing From WATC or a Private Financial Institution?

Important Issues for Local Government

This information aims to provide an overview of potential differences between the terms, conditions and pricing for the provision of debt finance to local governments by WATC in comparison to a private financial institution (PFI), or structured debt finance arrangements facilitated by a PFI(s), to assist local government in making informed decisions.

Introduction

As a result of recent changes to the State Government Guarantee Fee payable on the balance of all outstanding loans to local governments from Western Australian Treasury Corporation (WATC), along with the downgrade of the State's credit rating in recent years, the benefit for local governments borrowing from WATC, in comparison to PFIs, has been reduced.

Whilst WATC encourages its local government clients to research the financing options available to them to ensure they receive the most cost-effective financing outcome available, it is important that local governments are fully informed of the main differences, and the potential implications, of raising funding through WATC in comparison to a PFI.

Important Issues to Consider When Comparing Loans from Alternative Financiers

The majority of debt finance WATC provides to local government authorities are amortising long-term fixed interest rate loans for the development of specified community infrastructure. WATC fixed rate loans provide certainty on repayment structures for the entire term of the loan, consistent with the basis of local government budget submissions to council. Other forms of finance, such as short-term facilities, are also available from WATC. WATC's ability to provide these forms of debt finance stems from its long established process of raising long-term and short-term funding from debt capital markets secured by the guarantee provided by the Treasurer on behalf of the State of Western Australia.

By comparison, the methods used by a PFI to raise funds on debt capital markets can differ to that of WATC and therefore loan offerings to local government may differ in both tenure and structure. Consequently, this makes it difficult to compare interest rates with WATC loan offerings on a 'like for like' basis. In addition, there may be significant differences in other terms and conditions forming part of a loan agreement from WATC in comparison to PFIs.

The table below outlines important aspects of debt finance and other associated terms and conditions for WATC loans compared to the potential provisions that might be expected under PFI provision of debt finance to local government, including structured debt finance arrangements facilitated by a PFI(s).[1]

Key Financing Issue	WATC	PFI
Available loan tenure	Up to 20 years	Generally up to 7 years

[1] The assessment of potential PFI loan terms and conditions are based on WATC's research and understanding of loan offerings available from PFIs to local government, including structured debt finance arrangements such as the Local Government Funding Vehicle (LGFV) established in Victoria.

Key Financing Issue	WATC	PFI
Fixed Rate Loans	Fixed for term of the loan, with terms available up to 20 years.	Can generally fix for period of loan tenure provided (e.g. 3-7 years). Longer term fixed rate loans (e.g. 10 years or greater) may be available but generally subject to significant pricing premium, or refinancing provisions.
Floating Rate Loans – interest rate reset periodically based on changes in a market reference rate (e.g. 6 month BBSW)	Generally only provided indirectly through Short-term Facility – but potentially available through specific request for longer terms (e.g. out to 10 years).	Likely to be the standard basis of debt finance provided for terms of 3-7 years.
Short-term Facilities	Facility limit can be established up to 3 years, with potential for extension. Short-term borrowing rates apply only for drawn portion – no commitment or line fees.	May offer a 'revolving facility' up to a certain debt limit, valid for a certain period (e.g. 3 years). Commitment fee and/or line fees on undrawn portion likely to apply. Unsecured facility in the form of a bank overdraft also likely to be available – subject to higher interest rates and potentially commitment fees.
Establishment fees and other ongoing fees	No establishment fees to raise loans, no periodic ongoing management fees from WATC. State Government Guarantee Fee applies and is subject to change based on prevailing Government policy.	Establishment fee expected to apply for individual new loans. Ongoing fees may also apply depending on nature of loan[2]. Establishment and ongoing fees expected to apply for participation in structured debt finance arrangements.
Market valuation for loan prepayment/termination	Market valuation based on WATC buyback curve with tight spread to offered loan rates.	Spread between buyback and loan offer rates expected to be wider than WATC resulting in greater potential for higher market value premium payable.
Early Repayment Fees	No additional fees to repay a loan prior to the end of term, or to make unscheduled capital repayments.	Likely to be 'break costs' associated with early repayment in addition to the market valuation.
Refinancing	Available on existing and maturing loans. New applications and credit assessment required – but basis for pricing local government loans is generally not subject to change.	Generally available – but approval may be subject to PFI exposure limits and pricing basis may vary from original loan (i.e. in regards to PFI applicable lending margins).

2 For example, WATC understands that costs associated for involvement in the Victorian LGFV consisted of an upfront fixed fee, loan establishment costs in the order of 0.15% and ongoing costs in the order of 0.10% p.a.

Comparing Interest Rates for Fixed and Variable Rate Loans

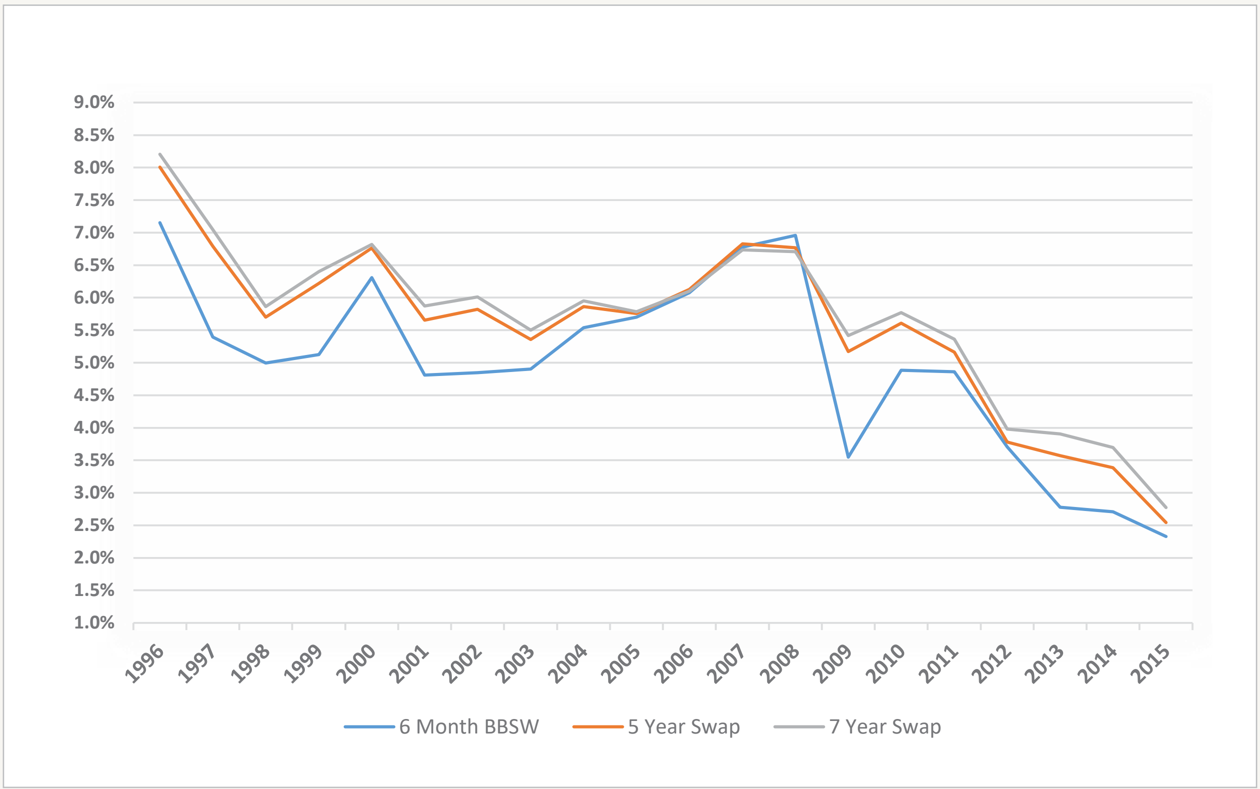
A primary source of PFI funding in wholesale debt markets involves the issuance of floating rate debt with tenure from three to seven years. Similarly, the debt issued by the Local Government Funding Vehicle in Victoria consisted of five and seven year floating rate bonds.

As such, it is generally cost-effective for a PFI to offer local governments floating rate loans to match its own source of funding. By comparison, over 70 per cent of WATC loans to local government are fixed rate with greater than 10 years to maturity.

Floating rate (or variable rate) loans have their interest rate periodically reset, generally every three or six months, with reference to a market benchmark rate – most commonly the Bank Bill Swap Rate (BBSW). Each time the interest rate on the loan is reset, it determines the interest payment due for the next period[3]. As such, for a seven year term floating rate loan with interest rate resets every six months, the applicable interest rate or future payments can differ significantly over the life of the loan.

Conversely, with a fixed-interest rate loan the borrower has a known and fixed repayment commitment for the full term of the loan, and is therefore insulated from movements in market interest rates. In essence, a fixed rate loan provides a form of insurance against rising interest rates – although noting that the borrower does not benefit from falling interest rates[4]. As such, a quote for a fixed rate loan is expected to be higher than for a variable rate loan of equivalent term.

Figure 1: Annual average of 6 month BBSW compared to 5 and 7 year fixed interest reference rates



[3] For further information on market reference interest rates and their impact on local government borrowing, please refer to the article: The Interest Rate Market and the Factors Affecting It - What Local Governments Need to Know.

[4] For further information on issues associated with fixed rate borrowing by local government, please refer to the article: Effective Management of Debt Finance for Local Government.

Consequently, if a local government is comparing a variable rate loan quote to a fixed rate loan quote for the same term to maturity, the cost of the 'insurance' associated with the fixed rate loan needs to be taken into account.

This can be interpreted by comparing the relevant market reference rates for floating rate debt such as the 6 month BBSW rate to the equivalent market reference for fixed interest rates – known in financial markets as 'swap rates'.

The cost of the 'insurance' varies over time as demonstrated in Figure 1, and can be approximated by the average difference over the 20 years from 1996 to 2015 between the 6 month BBSW and relevant fixed rate term, being 0.57% for the 5 year fixed rate and 0.73% for the 7 year fixed rate.

The volatility over time in both the level and relationship between reference rates for variable rate loans and term fixed rate loans is illustrated by Figure 1. Should a local government be offered a variable rate loan through a PFI, WATC can assist in interpreting prevailing market reference rates to provide guidance on:

- The interest rate of the PFI variable rate offering in relation to comparable WATC fixed and variable loan rates.
- The value for money associated with any offer from a PFI to convert a variable rate offering for a certain loan term to a fixed rate loan.

WATC is on Your Side

Understanding differences in loan terms and conditions and interpreting how they may affect the overall value of loan offerings between WATC and potential alternative financiers is a difficult process. However, it is important to understand that WATC's key motivation is to ensure the most appropriate and cost-effective informed financial decisions are made by our local government client base – irrespective of whether WATC is the provider of any required debt finance.

As such, should local governments be approached individually or collectively by a PFI(s) in regards to their debt finance needs, or seek quotes on loan offerings, WATC will willingly assist local governments to understand the key differences in offered interest rates and associated terms and conditions.

As local governments are aware, all loan applications with WATC are subject to a detailed credit assessment prior to approval. Whilst this is a necessary business requirement for WATC, it can also provide important independent feedback to a local government on their financial position.

In addition, where a local government has outstanding loan obligations with WATC, provisions within the lending agreement require the local government to obtain WATC approval prior to entering into a new loan agreement with a PFI or any other alternative financing arrangement.

WATC is at Your Service

This is the third article in the series aimed to provide local governments with a holistic view on relevant issues associated with debt financing. The other articles previously released in the series are:

- 'The Interest Rate Market & the Factors Affecting It – What Local Governments Need to Know'
- 'Effective Management of Debt Finance for Local Government'.

All articles are available on the dedicated page on WATC's website at: www.watc.wa.gov.au.

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