Understanding the Cost Implications for Early Repayment of WATC Loans

This information aims to assist clients in making informed decisions on debt management by explaining the potential costs associated with refinancing or making unscheduled repayments on individual loans and debt portfolios.

Introduction

WATC clients often enquire about repaying (in full or part) or refinancing / restructuring existing loans prior to their maturity. The motivation for these enquiries can vary widely, the most common reasons being:

- The client is holding a fixed rate loan(s) originating several years ago at a higher interest rate (e.g. > 6%) and wishes to refinance at the much lower rates available at present, or to repay the loan to avoid continually paying the higher interest rate.
- The client has surplus funds and wants to evaluate the relative benefit of paying down debt compared to investing the funds.
- The client has surplus funds (e.g. from asset sales) and has been instructed by management to repay debt and to minimise any applicable additional costs.

As such, the client will generally enquire if there are 'break costs' for terminating an existing loan(s). This resource seeks to inform WATC's clients on the costs associated with early repayment of loans in general, and how WATC applies the associated financial principles for loans to clients across the various debt products WATC offers.

What are Break Costs?

The term 'break costs' in financial literature as it applies to early repayment of loans can be a source of confusion. An internet search will result in several different definitions and explanations.

Essentially any costs for early repayment or refinancing can be broken into two categories:

1 - Market Valuation Effects

An adjustment to reflect any difference in the interest rate market from the time the loan was originally taken out to the current point in time for the remaining term of the loan.

The interest rates used for valuation should reflect the wholesale cost to the financial institution for funding the original loan, and the current wholesale cost for the financial institution to 'buyback' the liability in the wholesale debt market. This is also known as the 'fair value' of the loan.

It's important to note that if the current wholesale interest rate for the remaining term of the loan is higher than when the loan was taken out, this calculation will result in a discount – which should be passed onto the client (i.e. payout amount is less than the remaining loan balance).

2 - Administrative Costs

This category relates to a wide range of fees that may be charged to recover the cost of the administrative functions that the financial institution must undertake to discharge / restructure a loan. It may also include other fees to compensate the financial institution for the loss of income that results from a loan being retired early (i.e. taking into account the profit margin built into the loan rate offered to the borrower).

How Does WATC Determine the Cost of Early Repayment or Refinancing?

WATC only takes into account market valuation effects when determining the cost for repaying or refinancing a loan prior to maturity. The WATC Portfolio Position Report

[1] The reported field 'Market Value' also includes any interest accrued from the most recent interest payment date.

and Audit Report on client debt with WATC, distributed monthly and available through the WATC client portal, both include the field 'Market Value' which reflects the market value at the report date[1], either at the individual loan level or for the various portfolio aggregates presented.

What Should a Client Expect?

There is a greater likelihood that the market value of a loan (or debt portfolio) will be greater than the current balance outstanding (or 'face value') for both fixed rate and variable rate (i.e. term floating rate) loans provided by WATC – implying that a premium is payable to retire or refinance the loan. This is because:

- F**or term fixed rate loans**, under normal market conditions interest rates are higher the longer the term of the loan. Therefore, if a client wishes to repay a loan after it has been in place for several years (e.g. original 10-year loan, with 3-years remaining), the interest rate for the valuation will relate to the prevailing market interest rate for the remaining term of the loan being 3-years – which is likely to be lower than the original loan rate for the full term of 10-years.
- **For term floating rate loans** (TFRs), the 'margin' to the variable market reference rate (i.e. 90-day BBSW or 180-day BBSW) will be higher the longer the term of the loan. The market valuation calculation for a term floating rate loan will depend on the margin when the loan was taken out (e.g. 90-day BBSW + 0.4% for a 5-year TFR loan) compared to the prevailing margin for the remaining term of the loan when the client wishes to pay it out (e.g. 90-day BBSW + 0.1% for a 2-year TFR loan).

However, the general level of market interest rates that WATC is dependent on when determining client loan interest rates can vary significantly over time and this can therefore have a major impact on loan valuations.

This will include circumstances where discounts on early repayment will apply, which occurs if the current interest rate for the remaining loan term is higher than the original loan interest rate. These issues are covered in detail in the recent article released by WATC *The Interest Rate Market and the Factors Affecting It - What WATC's Clients Need to Know* also available at www.watc.wa.gov.au.

Debt Portfolio Manager

If a client wishes to buyback part of a debt portfolio managed through the Debt Portfolio Manager, WATC will determine the market value assuming the debt portfolio components closest to maturity are repaid. This is generally in the client's best interest because the difference between market value and debt outstanding is also a function of the remaining time to maturity of a loan, and therefore if premiums are payable they are more likely to be minimised.

Guarantee Fee

The State Guarantee Fee charged on WATC loans by the Department of Treasury is not part of the market valuation calculation. As such, there are no costs associated with the State Guarantee Fee when repaying loans early, and the Fee ceases to be payable once the loan is repaid. For this reason, in most cases, the option to repay a loan will be financially advantageous to a client compared to the alternative of investing surplus funds in short-term money market investments (e.g. term deposits) – regardless of whether a market value premium is incurred in repaying a loan early.

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