TREASURY MANAGEMENT STRATEGY 2016-2017

1) Purpose of Report

This report provides an update on the various loan renegotiations, an overview of the Association's funding needs and the approach to follow to ensure borrowing capacity and funding is in place for the development programme and special projects.

The report also reminds Members of the key treasury management risks and how it is proposed these are managed and mitigated.

2) Summary

The Board approved a comprehensive Treasury Management Strategy in May 2014, ensuring it complied with the CIPFA Code of Practice on Treasury Management.

The strategy was supplemented in April 2015 with a report detailing the actions to ensure the Association had sufficient funding needed for the following two years and increased the gearing limit to 75% and harmonise the interest covenant to 105%.

The loan renegotiations with Barclays and Santander are finalised and these have achieved the financial covenants as noted above. However, the negotiations with Nationwide BS have been slower and are still outstanding.

In September 2016 the Welsh Government announced that the funding for new developments will be through a 'blending' of Social Housing Grant (SHG) and Housing Finance Grant (HFG). This means the traditional net worth (loans to grant and reserves) gearing will not work! Whilst the grant blending is neutral upon the Association's cashflow, it pushes the traditional gearing calculation beyond 80%. Therefore, the current financial plans would breach the new 75% gearing limit. This grant funding change means it is important to arrange an alternative gearing basis. This change is proving to be problematic for Nationwide BS, as the preferred alternative gearing basis (historic cost: comparing loans to historic cost of properties), is not within Nationwide BS's lending policy!

The biggest risk to any organisation is the lack of cash to pay its bills. The critical nature of this risk was highlighted within the Altair report upon the near collapse of Cosmopolitan Housing Association. The lack of cash to fund development schemes is the biggest risk and therefore, it is important the Association has sufficient loan facilities to fund the committed development programme.

There is, therefore, a need to revise the Treasury Management Strategy to ensure:

(i) the gearing basis is changed to ensure it is 'fit-for-purpose' with the grant blending regime from Welsh Government and continues to provide greater borrowing and development capacity;
(ii) the provision of sufficient long term funding for the committed development programme.

The above requires the following to be agreed:

3) Recommendations

Members approved the following:

3.1 **Barclays**

(i) Converts the traditional net worth (loan to grant and reserves) gearing to a historic cost (loan to historic cost) basis; aiming for 55% limit;

(ii) Considers whether an overdraft facility is still required.

3.2 **Nationwide**

(i) Renegotiate a change in the covenants with Nationwide BS to remove the current Net Worth gearing covenant to an alternative that suits the needs of the business;

(ii) If renegotiation is unsuccessful, repays the pure £4 million Nationwide BS loans, incurring potential breakage costs of c£10,000;

(ii) Keeps the Nationwide 'Cheshire' loans as these have no gearing covenant.

3.3 **Santander**

(i) Converts the traditional net worth (loan to grant and reserves) gearing to a historic cost (loan to historic cost) basis; aiming for 55% limit.

3.4 **GB Social Housing**

(i) Arranges a new £4 million funding facility to refinance the £4 million Nationwide BS facility as noted in 3.2 above;

(ii) Arranges a new £2 million funding facility to finance the £2 million stock purchases during 2017.

3.5 **THFC (Welsh Government bond)**

(i) Arranges a new £4.5 million funding facility to finance the Cylch Caron Extra Care scheme;

(ii) Arranges a new £4.5 million funding facility to finance the future development programme.

3.6 **Orchardbrook**

(i) Releases the surplus security and charge to the Prudential Security Trustee, enabling the easier provision of security for future loans.

4) Background

From a Treasury Management perspective there are two key risks and these are explained below:

4.1 Lack of Cash

The biggest risk to any organisation is the lack of cash to pay its bills. The critical nature of this risk was highlighted within the Altair report upon the near collapse of Cosmopolitan Housing Association. The lack of cash is a particular risk when pursuing development schemes and opportunities given the significant sums of expenditure involved.

The Business Plan – Financial Projections 2016-51 document outlines the future flows of income and expenditure of the Association. The Association's policy is only to borrow to fund development activity. Therefore, the Financial Projections document outlines the future development expenditure and the requirement to arrange new loans to fund this development programme. This report expands upon the Financial Projections document to detail the specific actions and tasks that need to be undertaken during 2016 and 2017 to ensure appropriate loan funding is in place to finance the planned development schemes.

4.2 Breach of Funders' Covenants

The funders set a number of key financial covenants that must be complied with. In broad terms these are to ensure the Association does not over borrow and is always in a position to service the debt (paying the interest and repay the loans).

In addition to arranging new loan finance to fund the ongoing development programme, the Association has been negotiating with each of the funders to create more borrowing capacity. This is to ensure the Association can maximise its ability to provide new affordable homes. With a change in the way Welsh Government will provide grant funding from April 2017 the Association now needs to change the basis of the gearing covenant to ensure it is fit-for-purpose.

This report outlines the actions required for ensuring the above risks are managed and avoid the crystallisation of the risk.

5) Overview

The Association has a number of funders who between them have provided over £40m in loan facilities. At 30th September 2016, £39.2 million was outstanding, along with the undrawn £4 million RCF with Barclays Bank; £43.3m facility.

The loan finance has developed alongside the development programme and therefore many loans were scheme specific. The earliest loans date back to 1994, while the most recent was the GB Social Housing Bond arranged in 2015. The broad summary of the existing funding is given in the following table:

Loan Details	Nation-wide	Nation-wide/ Cheshire	Santander	THFC	GBSH	Barclays	Princi-pality	Orchard-brook
Loan arranged	1993 2001 2006	1997 2004 2008	2010 Renego-tiated 2016	1994 2013	2015	2016	1994	1999
Loan drawn & out-standing	***£4.2m***	***£15.7m***	***£10.0 m***	£4.6m	£3.5m	£0.0m	£0.6m	£1.3m
Facility undrawn	None	***None***	***£2.0m***	None	None	£4.0m	None	None
Final repayment	2028 2031	2033 2038 2040	2026	2024 2044	2045	2021	2028	2044
Margin	1.0%	0.45% 0.75%	1.65%	N/A	N/A	1.50%	0.5%	N/A
Weighted interest rate	***2.29%***	***3.91%***	***5.19%***	***6.98% and 4.53%***	***4.61%***	***N/A***	***0.99%***	***10.17%***
Interest cover	115% Surplus to interest	110% Surplus to interest	*105% Surplus to interest*	100% Surplus to interest	None set	105% Surplus to interest	175% Gross rent to interest	?
Gearing (Net Worth)	65% Debt Service Test	None set Debt Service Test	*75%*	None set Debt Service Test	None set	75%	None set	None set Debt Service Test
Security	125% EUV-SH 125% MVT	111% EUV-SH 117% MVT	105% EUV-SH 125% MVT 130% SO	150% MVT	140% EUV 150% MVT	110% EUV-SH 130% MVT	133% EUV-SH	130% EUV-SH
Spare security	£4.8m	£3.4m	*£1.0m*	£4.4m	£2.7m	£2.0m	£2.9m	£2.9m

The most restrictive loans, in terms of financial covenants are the ‘pure’ Nationwide BS loans, whereas the ex-Cheshire loans only have an interest cover covenant.

The most expensive loans, in terms of interest cost, are the Orchardbrook loans, which have 10.17% fixed interest until 2044, and the 1994 THFC indexed bond. This THFC bond has the interest cost inflated by RPI each year and therefore the interest cost increases each year, and is completely independent from the interest rate market. The effective interest rate on this loan is currently 6.98%.

In the difficult economic and financial climate since 2008, the interest rate margin on new loans has increased significantly. New loan margins are c2% and the Santander margin of 1.65%, and Barclays at 1.50% are essentially the only market rate margin the Association is currently paying. However, long term fixed interest rate arrangements are still possible at below 6% interest, with margins at 2%. Therefore, the high margin in itself does not mean high cost interest on loans.

The net worth gearing (loans to grant and reserves) traditionally was the normal gearing covenant used in loan documents. However, with a change in the grant funding regime by the Welsh Government as outlined in the separate report concerning grant blending, this net worth gearing covenant is no longer fit for purpose. Therefore, negotiations have started with funders to get this changed to a more commercial basis; historic cost (loans to historic cost of properties).

6) New Loan Facilities Required

As noted previously, one of the underlying financial principles is only to borrow to invest in new homes or where the investment enables the rents to be increased. The Business Plan financial projections include the development plans and aspirations over the next five years. These are summarised in the table below:

The current development plans and associated loan funding requirements are highlighted below:

Description		2016/17 £'m	2017/18 £'m	2018/19 £'m	2019/20 £'m	2020/21 £'m	2021/22 £'m	Total £'m	
Units		**47**	**176 (i)**	**52**	**79 (ii)**	**40**	**40**	**434**	
Standard development									
Total	Spend	2.8	9.1	5.9	5.5	5.8	6.3	35.4	
	Grant	0.6	2.3	2.1	1.7	1.6	1.2	9.5	
	Loan	**2.2**	**6.8**	**3.8**	**3.8**	**4.2**	**5.1**	**25.9**	(iii)
Cylch Caron – Extra Care			**4.5**					**4.5**	
Pobl properties		**1.8**						**1.8**	
Bromford properties		**3.5**						**3.5**	
EOM purchase		**0.5**						**0.5**	
Total loan required		**8.0**	**11.3**	**3.8**	**3.8**	**4.2**	**5.1**	**36.2**	
Loan Facility									
Unused		**-6.0**						**-6.0**	
Required in year		**2.0**	**11.3**	**3.8**	**3.8**	**4.2**	**5.1**	**30.2**	
Cumulative Required		**2.0**	**13.3**	**17.1**	**20.9**	**25.1**	**30.2**	**30.2**	

Note

(i) The 176 units in 2017/18 includes the 98 Bromford and 39 Pobl properties;
(ii) The 79 properties in 2019/20 includes 40 for Cylch Caron;
(iii) The original loan requirement for the standard development pre-grant blending was £20.1 million.

There is a requirement for just almost £26 million of long term loans to fund the standard development plans over the next six years; an average of c£4 million each year. With a development scheme taking up to two years to complete, the average funding requirement over a two-year period is c£8 million.

In addition, the Association is pursuing four specific projects as highlighted in the table above. Each of these projects requires loan funding. The funding needs of these projects could require a further £5.8 million loan funding in the 2016-17 financial year and a further £4.5 million in 2017-18; a total of £10.3 million.

The Association, therefore, has a funding requirement for c£18 million over the next two years and currently has £6 million available. Therefore, the Association would need to arrange a further £12 million in loan facilities to fund the total development plans for the next two years.

The sources of long term funding remain limited. As noted previously banks would like shorter term loans. Therefore, the longer term funding requires a bond, either through GBSH (GB Social Housing) or THFC (The Housing Finance Corporation). With regard to THFC this could include the Welsh Government sponsored scheme including funding from the EIB (European Investment Bank).

When bond finance is arranged the funding is provided on the day the bond is arranged. Therefore, the Association could end up with a large loan which is not required for over 12 months. This is where having a Revolving Credit Facility (RCF) is very useful. Any bond finance that is in excess of the immediate needs can be used to repay any drawn RCF. Therefore, the Association needs to ensure it has RCF that at least matches the bond finance being arranged. The existing £4million RCF with Barclays Bank is therefore considered appropriate.

It is, therefore, proposed that funding offers are sought from GBSH and THFC.

7) <u>Financial Covenants</u>

The Association has been renegotiating with the funders for a change in the gearing and interest cover covenants to ensure it could use the borrowing capacity within the Association's cashflows as demonstrated within the financial forecasts.

The Association had agreed, in principle, an increase to 75% for the gearing (on a net worth: loans to grant and reserves basis) and reduction to 105% for the interest cover.

However, the changes in the Welsh Government grant funding arrangements will result in the additional borrowing capacity, from having a 75% gearing level, 'disappearing' as a result of this grant blending. This is explained in detail in a separate report on the agenda.

The consequence of the grant blending is that the net worth (loans to reserves and grant) gearing basis is no longer suitable. Alternatives have been discussed with funders and from a business perspective the most appropriate gearing basis for the future is historic cost (loans to historic cost of properties). Therefore, wherever a gearing basis exists in the loan documents, this needs to be changed to a historic cost basis.

With regard to this renegotiation, over gearing basis, whereas Barclays and Santander are very happy to make such a change, Nationwide BS have confirmed such a basis is outside the building society policy. Therefore, the only avenue for getting the historic cost basis across all the loan is to repay the 'pure' Nationwide loans, through the refinancing with another funder.

The current loans with Nationwide only have 12 to 15 years remaining. However, given the reduced loan period with Santander, the refinancing of the Nationwide BS loan with a longer term loan facility removes a potential refinancing risk in 12 to 15 years' time. With interest rates remaining low it is possible that the costs of a loan arranged in the next 12 months could be at a lower rate of interest than in 12 to 15 years' time.

8) <u>Treasury Management Strategy</u>

With the Association having a number of different funders, there have been a number of different discussions and meeting to determine the best approach to achieve the requirements of:

(i) Ensuring an ongoing Revolving Credit Facility (RCF), to provide working capital during the construction phase of a new development and flexibility in timing when arranging bond finance;
(ii) Provide sufficient long term funding for the committed development programme;
(iii) Increase the gearing limit to provide greater borrowing and development capacity.

Therefore, there are several actions being proposed during 2016 and 2017 to support this strategy as outlined below.

8.1 Barclays

The Association has a £4.0m Revolving Credit Facility (RCF) with Barclays. This is a five-year facility completed in September 2016. This is on a variable interest basis only. The broad details of the loan are given in the table below:

	Loan	Start	Term end	Margin	Gearing	Interest cover	Security	Surplus security
Barclays	£4.0m	2016	2021	1.50%	75%	105%	120% EUV-SH	£2.0m
						(a)		(b)

Note
(a) The interest cover includes the component replacement expenditure within the calculation;
(b) The surplus security figure indicates the additional amount of loan that could be supported without providing any further security.

Barclays are the Association's corporate bankers. They provide the day-to-day banking and overdraft facilities. The provision of the RCF is akin to a longer term overdraft facility and therefore fits well alongside the day-to-day banking services. However, consideration could be given to ceasing the overdraft facility given the existence of the RCF.

As noted in section 7 above, concerning gearing covenants, negotiations need to be finalised upon changing the gearing basis to historic cost.

Actions:

It is therefore proposed to undertake the following during 2016 and 2017:

a. Maintain the Barclays £4.0m Revolving Credit Facility (RCF);
b. Change the gearing basis to historic cost at no less than 55%;
c. Review whether the overdraft is still required.

8.2 Nationwide BS (including ex-Cheshire loans)

The Association has a £20m loan facility with Nationwide. This is a mixture of Nationwide and former Cheshire Building Society loans. The earliest loans were arranged in 1993 and the most recent in 2008 (with Cheshire BS). The majority is fixed interest, with just under £6m being variable interest. The facilities end between 2028 and 2040.

The loans have a mixture of margins and financial covenants, although they all have a common gearing covenant of 65%. The broad details of the loan are given in the table below:

	Loan O/S	Start	Term end	Margin	Gearing	Interest cover	Security	Note
Nationwide	£1.4m	1993	2028	1%	65%	115%	125% EUV-SH 125% MVT	
Nationwide	£0.8m	2001	2028	1%	65%	115%		
Nationwide	£2.0m	2006	2031	1%	65%	115%		
Cheshire	£1.1m	2004	2033	0.45%	None	110%		
Cheshire	£1.0m	2002	2028	0.45%	None	110%		
Cheshire	£2.6m	2004	2040	0.40%	None	110%		
Cheshire	£8.6m	2008	2038	0.75%	None	110%		
Cheshire	£2.3m	2008	2033	0.50%	None	110%		(b)
Total	£19.8m				(a)		(c)	

Note

(a) There is no gearing covenant set by Cheshire BS. Instead, there is a Debt Service Reserve calculation to demonstrate if there is sufficient net income from the properties to repay the loans with the loan period.

(b) This loan, arranged in 2008, was specifically to fund the offices; hence shorter term of 25 years. However, subsequently Nationwide BS declined to accept the offices as suitable security.

(c) The security cover is at 125% regardless of valuation basis. Therefore, there is no benefit of securing properties to Nationwide where there is a restriction in value to EUV-SH.

Nationwide became the Association's principal funder after they acquired Cheshire BS in 2009. They wish to remain long term funders to the Association but are not interested in increasing the amount of loans with the Association. In addition, they are unable to offer a historic cost gearing basis.

Therefore, the Association will need to refinance the 'pure' Nationwide BS loans if it wishes to avoid a restrictive and inappropriate gearing covenant. Given the Nationwide ex-Cheshire loans have no gearing covenant in place these loans don't have the same restriction. Given the ex-Cheshire loans also have the lowest funding margins, there is no advantage in the Association also refinancing these ex-Cheshire loans.

The £4 million Nationwide BS loans are mostly fixed rate and therefore breaking these fixes will incur breakage costs. Nationwide BS have been asked to provide indicative costs for such a break. For budget purposes it has been assumed these costs could amount to £100,000.

Action:
It is therefore proposed to undertake the following during 2016 and 2017:

a. Repay the £4 million 'pure' Nationwide BS loan.

8.3 Santander

The Association now has a £12m loan facility with Santander that ends in 2026. The majority of the loan is fixed interest. This facility was originally arranged in 2010 and was primarily to fund the Ffordd Croesawdy and Heol Rhedyn developments within Newtown. This loan was restructured in 2016 to a shorter facility, giving a 10-year loan from 2016. This reduced loan term was in exchange for the higher 75% net worth gearing level. The broad details of the loan are given in the table below:

	Loan	Start	Term end	Margin	Gearing	Interest cover	Security	Surplus security
Santander	£12m	2010	2026	1.65%	75%	105%	105% EUV-SH	£1.0m
						(a)		(b)

Note

(a) The interest cover includes the component replacement expenditure within the calculation;
(b) The surplus security figure indicates the additional amount of loan that could be supported.

Santander is the second largest funder of the Association. The funding terms are all up to date following the loan restructure in 2016. However, a further change is now required to change the net worth gearing covenant to a historic cost basis. The discussions with the Santander Lending Manager has confirmed that such a change is acceptable in principle, although the level needs to be agreed to ensure it is consistent with the current 75% net worth basis.

Action:
It is therefore proposed to undertake the following during 2016 and 2017:

a. Change the gearing basis to historic cost at no less than 55%.

8.4 New Facility

As noted previously, one of the underlying financial principles is only to borrow to invest in new homes or where the investment enables the rents to be increased. The Business Plan financial projections include the development plans and aspirations over the next five years as outlined in section 6 above. This indicates the Association needs to potentially to arrange a further £10 million loan facility.

In addition, the refinancing of the £4 million Nationwide BS loan also requires a further loan facility.

Therefore, over the next 12 months the Association needs to arrange £14 million in loans. The Welsh Government is promoting a new bond finance through THFC using EIB (European Investment Bank) monies. This WG bond is likely to be the cheapest available funding. However, it is not expected this funding will be in place until September 2017. Therefore, it is proposed to arrange any loan funding required prior to this date with GBSH, and after this date with THFC. The current indication of funding requirements before and after this date is given in the following table.

Description		2016/17 £'m	Pre Sept 2017 £'m	Post Sept 2017 £'m	2018/19 £'m	Total £'m
Units		**47**	**176 (i)**		**52**	
Standard development						
Total	Spend	2.8	4.2	4.9	5.8	17.8
	Grant	0.6	2.0	0.3	2.1	5.0
	Loan	**2.2**	**2.2**	**4.6**	**3.7**	**12.8**
Cylch Caron – Extra Care				**4.5**		**4.5**
Pobl properties		**1.8**				**1.8**
Bromford properties		**3.5**				**3.5**
EOM purchase		**0.5**				**0.5**
Total loan required		**8.0**	**2.2**	**9.1**	**3.7**	**23.1**
Loan Facility		**-6.0**				**-6.0**
Unused		**2.0**	**2.2**	**9.1**	**3.7**	**17.1**
Required in year		**2.0**	**4.2**	**13.3**	**17.1**	**17.1**

It is, therefore, proposed that a funding offer is sought from GBSH now and THFC during 2017.

Actions:
It is therefore proposed to undertake the following during 2016 and 2017:
a. seek funding offers from GBSH for facilities of between £4.0 and £9.0m;
b. seek funding offers from THFC for facilities of between £4.5 and £9.0m.

9 Financial Implications

There are a number of objectives the Association is trying to achieve through its Treasury Management Strategy:

(i) arrange new loan funding to pursue the development plans outlined in the Business Plan financial projections 2015-2045 document;
(ii) change the gearing basis to ensure it is 'fit-for-purpose' with the grant blending regime from Welsh Government, enabling the previously negotiated greater borrowing and development capacity to be used;
(iii) maintain an ongoing Revolving Credit Facility (RCF) to fund the development programme during construction and enable bond finance to be arranged as the long term funding of those schemes;
(iv) repay the Nationwide loan to remove the restrictive gearing covenants.

There are costs to each of the above and these are summarised in the table below:

Description		Nationwide £'000	GBSH £'000	THFC £'000	Total £'000	Note
One-off costs						
Arrangement fees			65	55	120	Costs based on maximum £12m new loan at 1% arrangement fee
Breakage costs		100			100	Indicative from Nationwide BS
Security work			25	35	70	Legal cost to secure properties
Legal costs			40	50	90	New loans
Total		**100**	**130**	**140**	**305**	

The total costs of arranging new loans, renegotiating the gearing basis and repaying the Nationwide loan will be c£300,000. Some of these costs, like the arrangement costs, can be capitalised and charged to the income and expenditure account over the life of the loan. Other costs, like the breakage costs are an additional cost to the income and expenditure account.

There should be no additional interest costs arising from changing the gearing basis as the negotiations are to agree on a historic gearing level that is consistent with the previously arranged 75% net worth basis.

10 Risk Assessment

SR14/016	Existing Debt	Existing debt – managing existing debt to ensure covenants are complied with	10 amber

The Risk Register has compliance with covenants as a high risk. It is important to ensure that whatever gearing basis is agreed, that it is closely monitored and managed to ensure it is complied with.

The renegotiation of the gearing to an historic cost basis is to enable the Association to actually use the greater headroom the previously arranged 75% net worth gearing was designed to provide. This change removes the possibility of breaching the covenant.

In the short term it is important that the Association remains compliant with the 75% gearing level that has previously been agreed.

11 Impact Assessment

11.4 Tenants

No tenants have been directly involved in this report. However, a tenant is on the Finance & Risk Committee and therefore a tenant perspective can be taken into account when considering the report.

The purpose of the gearing change and additional loan funding is to ensure the Association can deliver its objective of providing more affordable homes across Mid-Wales.

11.5 Other Stakeholders

This report has included information from each of the Association's funders. The cost indications have been provided by the funders. However, there have been no formal funding offers from any of the funders and therefore, the figures illustrated could change.

11.6 Equality and Diversity

There are no equality and diversity issues arising from these reports.

11.7 Welsh Language

There are no direct implications relating the Welsh language.

12 Conclusion

There are a number of actions required during 2016 and 2017 under this Treasury Management Strategy. As noted above the broad objectives during the year are:

(i) arrange new loan funding to pursue the development plans outlined in the Business Plan financial projections 2015-2045 document and refinance the £4 million Nationwide BS loan;

(ii) change the gearing basis to historic cost to ensure the previously renegotiated greater borrowing capacity can be used to fund a larger development programme;
(iii) maintain an ongoing Revolving Credit Facility (RCF) to fund the development programme during construction and enable bond finance to be arranged as the long term funding of those schemes;
(iv) repay the £4 million ‘pure’ Nationwide BS loan.

The one-off costs of the actions for the above will be around £300,000. With the exception of the breakage costs, these costs have already been included in the financial forecasts and therefore, within existing budgets.

As a result of these changes the Association will have borrowing capacity and development funding in place for the next two to three years.

Charles Brotherton
Director of Finance
cbrotherton@mid-walesha.co.uk
01686 620502
15th November 2016