4. DEBT REPAYMENT ARRANGEMENTS

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The purpose of this report is to recommend a change in the way provision is made for debt repayment by the Council.

BACKGROUND

The Council currently provides for the repayment of its loans by making annual contributions to a sinking fund in respect of each of its loans. There are some minor exceptions to this where alternate repayment provision is made (such as table mortgages) but generally the sinking fund method of debt repayment has been used in the past.

A sinking fund is a fund which accumulates contributions and earns interest. The contributions are mathematically calculated to provide sufficient from the combined contributions and compounded interest for the repayment of the loan at the end of its term which is normally 20 years. Sinking Funds are held in trust for the Council by a separate legal entity known as the Sinking Fund Commissioners. This Council has appointed the Mayor, City Manager and the Director of Finance as its Sinking Fund Commissioners. While the funds are managed by Council staff they are invested and held separately from the Council finances.

The current process follows a methodology which was a requirement of the former Local Authorities Loans Board and the legislation under which it operated. This legislation was repealed with effect from 1 July 1998. The Council still needs to make sinking fund contributions for existing loans but it now has more flexibility as to how it provides for debt repayment for new loans. The Council's Borrowing Policy provides as follows:

Debt may be repaid by one or a combination of:

- *Annual Sinking Fund Instalments where the Sinking Fund Commissioners hold the funds as a separate trust, for the Council, for the sole purpose of debt repayment of specific loans*
- *Annual Contributions to a Loan Repayment Reserve to be held by the Council for the sole purpose of applying, at appropriate opportunities, to the repayment or reduction of loans*
- *Annual table repayment instalments providing for full repayment over the term of as loan being 20 years or less.*
- *Repayment from revenue or other sources.*

ISSUES FOR CONSIDERATION

The current sinking fund approach keeps separate sinking funds for each loan. When each loan comes up for renewal (often five to six times during its 20 year life) then the sinking fund is drawn upon to repay part of the loan and the balance is re-financed for the remaining term of the loan and a new sinking fund established for the reduced term of the renewal loan.

Because the current sinking fund regime requires separate funds for each loan there are generally some funds on hand for existing loans at the same time as the Council goes out to borrow for the remaining part of a loan which has come up for renewal.

Sinking funds are invested at market rates but this is generally less than the borrowing rate. Thus there is a financial inefficiency where funds remain invested while new borrowing takes place.

Sinking Funds are invested separately from Council investments in the name of the Sinking Fund Commissioners. There would be considerably more flexibility if sinking funds could be part of the Council's general investment portfolio.

PROPOSED CHANGE

It is proposed that the Council establish a new Loan Repayment Fund which would be for the sole purpose of making provision for the repayment of loans. This fund would be credited with an annual contribution for loan repayment in respect of every Council loan (except those which are under the existing Sinking Fund Regime) and the fund would earn interest which is credited to the fund. The fund would not be compartmentalised for individual loans and the full proceeds would be available to be applied to all loans which are due for repayment or renewal at any point in time. This would maximise the benefit of the accumulated funds.

In practice, there will be minimal funds on hand in the loan repayment fund at any given time, since available cash on hand will be applied to meet renewals as they fall due. This is a more efficient use of cash resources.

Since funds would not be available to earn interest for as long a period as the normal sinking fund formula would anticipate (i.e. 20 years), the contributions to the fund would need to be recalculated every time a withdraw is made to compensate for the reduced interest earning potential and reduced amount left to be repaid. This would increase the annual contributions rate, but it would be calculated on a lower base and the extra contribution could be funded from the savings in interest cost from a more rapid reduction in the level of outstanding debt. Because there is an interest differential between investments and borrowing there would be overall savings for the Council. The method of recalculating the contributions would be based on a weighted average of the remaining term of the individual participating loans outstanding.

Sinking Funds in their existing form would be phased out as the current loans are repaid or renewed under the newly proposed regime.

DIFFERENCE FROM THE EXISTING DEBT REPAYMENT RESERVE

The Council currently has a Debt Repayment Reserve but this has a different purpose to what is being proposed in this report. The Debt Repayment Reserve was established from capital repatriation funds and has been set aside specifically to reduce Council debt by repayment of loans in full as they mature or to fund the capital expenditure programme to avoid raising new loans. The interest on this fund is available for general income purposes and is not credited to the fund. As intended the Debt Repayment Reserve will be run down over the next two years as the lump sum received is applied to its purpose.

The proposed Loan Repayment Fund will be set up to provide a way of repaying all new loans raised from this point forward.

Recommendation:

1. That a Loan Repayment Fund be established for the purpose of providing for repayment of all loans borrowed by the Council from this time forward.

2. That contributions be made to the fund in respect of all participating loans based on a weighted average repayment factor which ensures that all loans will be repaid in no more than 20 years and that the contributions be not less than 3% of outstanding loans in accordance with the existing borrowing policy.

3. That interest earnings be credited to the fund.

4. That the full accumulated funds and earnings be applied to the maximum extent possible for repayment of any participating loan which comes up for renewal or repayment.