Debt Management

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WORLD BANK GROUP
Water

wsp
water and
sanitation program

Objective

To develop an understanding of the importance of carefully managing all debt incurred by the service provider – and guide client WSPs on efforts to improve their debt management capacity

Outline

1. Financing investments
2. Building capacity to borrow
3. Debt management policy
4. Debt management practices

Key Messages

Pre-conditions to borrowing from commercial lenders is a positive cash flow, good coverage ratios and effective financial management and internal control systems.

Formal debt management policies are essential to ensure that all borrowings are in accordance with corporate policies and procedures and consistent with the business plan.

A separate debt management unit is important to ensure the proper monitoring of the WSP ‘s debt and the compliance with the various debt covenants

Financing Investments

Financing Investments

In order to expand service coverage to the levels demanded by customers and government, most service providers need to have huge capital spending plans. Those investment plans can be financed from:

- Transfers and taxes – public funding
- Tariffs – net cash flow from operations and
- Commercial finance - loans and bonds issued by the service provider and repaid from its future net cash flows and public funding

Building Capacity to Borrow

Building Capacity to Borrow

Before borrowing money to improve and/or expand service levels, the existing operations must be well managed and generating positive net cash flows with good operating cost coverage ratios

Service providers should have well developed management systems and effective financial and internal control systems based on a sound budgeting process

Service providers should have strong and realistic business plans and the capacity to identify and develop bankable projects

Discussion Point

Do the financial institutions of the region/country consider the water sector as financially viable and as potential borrowers of commercial funds?

1. Yes
2. No
3. Not sure

Discussion Point

Once the service provider has the capacity to borrow how much debt should it borrow – what is its borrowing capacity? There are three options:

1. Determine the investment requirements then look for financing to provide the needed funds
2. Determine how much can be borrowed and still remain within financial parameters determined to be in the financial best interest of the service provider
3. Keep the creditworthiness untouched by having a high credit rating but never making use of it

Borrowing Capacity

Fairfax County, Virginia is one of the largest and best managed counties in the United States. In the early 1990s, it adopted a formal capital financing policy which prescribed that outstanding debt would not exceed 1.75 percent of the market value of taxable property [*total debt to property value ratio*] and that debt service would never exceed 10.0 percent of total (general fund) revenue [*debt service to total revenue ratio*].

Option 2 is by far the best approach

Challenges & Action Planning

Poor Management of Resources

16. DEBT problems
A. Short-Term Debt being rolled over
B. Long-Term Debt too large
C. Long-Term Debt in foreign currency
D. Debt Management Unit weak/none
E. Debt Policies & Procedures poor

Potential Actions

Action 16.1 Establish written policies and procedures governing debt management that strictly require the use of long term debt only for capital investments and the use of short term debt only for liquidity management within the limits of a fiscal year. [E]

Action 16.2 Establish a written financial management policy that strictly prohibits borrowing to offset an Operating Deficit at the end of a fiscal year. [A/E]

Action 16.3 Establish written policies and procedures governing debt management that strictly require all debt to be only in local currency. [C/E]

Action 16.4 Establish written policies and procedures governing debt management that establish prudent limits to the level of debt service that can be taken on. [B/E]

Action 16.5 Establish debt management safeguards against late or missed debt service payments and violation of any conditions or covenants contained in their debt agreements. [D]

Action 16.6 Establish a debt management unit within the finance department to perform risk management and cash management functions including carefully planning all borrowings, maintaining records of all debts and reporting on their status regularly. [D]

Action 16.7 On a project by project basis, compare the cost of borrowing through a variety of mechanisms, including the use of public private partnerships, to the cost of delaying or canceling the project. [B]

Action 16.8 Review outstanding debt for opportunities for restructuring/refinancing to reduce annual debt payments and total costs. For new debt, if possible, maintain an option for future refinancing. [E]

Action 16.9 Identify, review and minimize all contingent liabilities. [D]

Debt Management Policy

Debt Management Policy

A debt management policy provides written guidance about the amount and type of debt that can be incurred, the process for incurring debt and the management of the debt in line with the service provider's resources.

The policy must be approved by the water service provider's governing body and comply with all applicable government standards.

The policy should be thorough and conservative.

Debt Management Policy – Principles

Some key debt management principles include:

The service provider will incur debt only in the case where there is an identified source of repayment. Debt will be incurred to the extent that:

- projected existing revenues are sufficient to pay for the proposed debt service together with existing debt service covered by such existing revenues, or
- additional revenues have been identified as a source of repayment in an amount sufficient to pay for the proposed debt.

The service provider will not use debt to cover current operating costs, except to manage cash flow during the financial year

Debt Management Policy – Principles…

The proceeds of any debt obligation shall be expended only for the purpose for which it was authorized

Long-term debt shall only be used to finance capital improvements (and not operational requirements)

Short-term debt must be repaid within the financial year and never rolled over

Debt will be structured for the shortest period possible, consistent with a fair allocation of costs to current and future users

Debt Management Policy – Principles…

Debt should be of a duration that does not exceed the useful life of the improvement that it finances and where feasible, should be shorter than the projected economic life

The service provider shall never be responsible for foreign exchange risk in any debt transaction

When appropriate, the service provider may choose to issue securities that pay a rate of interest that varies according to a predetermined formula

Debt Management Policy – Types of Debt

A debt management policy should specify the types of debt that can be incurred and the appropriate use for each:

Bank loans – less than 1 year (short-term) for liquidity management

Bank loans – more than 1 year (medium-term) to finance capital improvements, vehicles and equipment

Capital lease – to finance capital improvements, vehicles and equipment

Long term loans/bonds – including revenue bonds, revolving fund bonds, sinking fund bonds and debentures (un-secured) for major capital investments

Debt Management Policy – Restructuring

Reasons for restructuring/refunding existing debt:

1. The restructuring results in net present value savings
2. The restructuring is necessary due to a change in the use of a project that could impact its future cash flows
3. The service provider's governing body determines by resolution that the restructuring of the debt results in changes to the debt service that are in the service provider's best interest

Debt Management Policy – Other

Some of the other issues to be addressed in the debt management policy include:

1. Funding strategies
2. Methods of choosing lenders/investors – competitive or negotiated
3. Maintenance of credit quality – what is the goal regarding the service provider's credit rating
4. Risk assessments guidelines
5. Rules governing transparency and disclosure
6. Use of professional services (a public finance adviser and other specialized service providers to issue debt)
7. Asset ownership

Debt Management Practices

Creditworthy Debt Management

Remember the definition of creditworthiness?

Creditworthiness means the ability and willingness to repay debts on-time and in-full.

But…

Creditworthiness also requires that the service provider is willing and able to comply with the terms, conditions and covenants in the various loan and bond agreements.

Covenants

What are some possible covenants that would need to be managed?

Tariff covenant

- tariff increases linked to pre-agreed operational and financial targets.

Security of project assets

Right of set-off

- the right to set-off debt service payments from other bank accounts held by the borrower.

O&M covenant

- system must be operated and in an efficient manner and maintained in good working order.

Covenants…

Some common ratios that covenants require to be maintained include:

Debt service coverage ratio –

- net operating income/total debt service payments –
- normally set between 1.2 and 2.0

Times interest earned ratio –

- earnings before interest and taxes (EBIT)/ interest payable –
- a ratio of1.5 would be a minimum

Debt to equity ratio (gearing) –

- total debt/total equity – the larger the ratio the greater the risk

Monitoring the Service Provider's Debts

It is important to record and monitor key information about each debt, including the covenants and repayment requirements of the various loans and bonds including:

- Original issue and maturity dates;
- Original amount borrowed and the outstanding balance;
- Interest rates, payment due dates and debt service payments made;
- Status of key ratios and other covenants;
- Dates for future requirements.

Discussion Point

Do companies – WSPs – need a separate unit to manage/monitor their debt or should these issues be dealt with by the Treasury Department?

1. Yes
2. No
3. Not sure

Debt Management Unit

Being creditworthy requires the ability to repay debts on time **AND** comply with all related debt covenants.

Monitoring all of the various aspects of a service provider's portfolio of debt to ensure that the service provider is in compliance with all of the covenants requires the attention of a separate unit or team within the Finance Department.

Debt Management Function

The unit or team responsible for Debt Management should be:

- In control of the structuring and negotiation of all short- and long-term debt transactions undertaken by the service provider
- Able to access independent financial and legal advisers for structuring and negotiation of all short- and long-term debt
- Responsible for ensuring timely debt service payments and fulfillment of all terms and covenants of debt agreements
- Responsible for production of periodic reports on outstanding debts
- Free of undue political interference

Conclusions

Limit the amount of borrowing to maintain financial capacity/creditworthiness of the WSP

A creditworthy WSP has the ability to repay debts on-time and in-full AND comply with all loan covenants and conditions

The debt management unit provides needed monitoring and oversight of debt service payments and compliance with debt covenants

Thank you

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