Approach to interest rate setting for Housing Zone loans

29 April, 2015

1. Housing Zones

1.1. The factors the GLA will take into account when setting interest rates for Housing Zone loans are set out below to help inform partners and encourage them to provide the fullest information possible. These apply where the loan is interest-bearing only, in some cases the lending may be on a value-linked basis.

2. Summary

2.1. The table below summarises the interest rates offered for Housing Zone loans, calculated on the basis of guidance from the European Commission (EC) combined with a margin to reflect the GLA's risk.

Creditworthiness	**Collateralisation**		
	High	Normal	Low
Strong (AAA-A)	2.87%	3.02%	3.27%
Good (BBB)	3.02%	3.27%	3.47%
Satisfactory (BB)	3.27%	4.47%	6.27%
Weak (B)	4.47%	6.27%	8.77%
Unsatisfactory (CCC and below)	6.27%	8.77%	12.27%

2.2. So, a counter-party with a satisfactory creditworthiness and a normal level of collateralisation would be charged a rate of 4.47%.

2.3. Please note that for long-dated debt (i.e. a repayment of more than five years from drawdown) a premium may be applied by the GLA to the above rates, to reflect increased levels of risk. This premium will be calculated with reference to the relevant Public Works Loan Board (PWLB) 'certainty rate' for that term plus an allowance for the GLA's costs. For reference the PWLB 'certainty rate' after allowing for the GLA's costs is currently is some 2.38% for 5 year money; 2.94% for 10 years; and 3.26% for 15 years compared to an equivalent starting rate of 2.27% before assessment for creditworthiness and collateralisation.

3. Creditworthiness

3.1. The level of creditworthiness is defined by Standard and Poor's as follows:

- 'A'—Strong capacity to meet financial commitments, but somewhat susceptible to adverse economic conditions and changes in circumstances.
- 'BBB'—Adequate capacity to meet financial commitments, but more subject to adverse economic conditions.

- 'BB'—Less vulnerable in the near-term but faces major ongoing uncertainties to adverse business, financial and economic conditions.
- 'B'—More vulnerable to adverse business, financial and economic conditions but currently has the capacity to meet financial commitments.
- 'CCC'—Currently vulnerable and dependent on favourable business, financial and economic conditions to meet financial commitments.

3.2. Where a counter-party has a recognised credit rating this will obviously be used to assess their creditworthiness. Where a counter-party does not have a rating, the GLA will assess their creditworthiness in a manner consistent with the ratings issued by such agencies. This involves an assessment of the bidder's Financial Standing and the risks associated with lending to that business – principally their capacity and willingness to pay. Considerations may include:

- Profitability, turnover, net asset position, gearing, debt maturity profile, industry sector
- Assessment of the trading history and development experience of a borrower
- The ability of the borrower to service the loan
- Review of accounts, credit checks, references
- Benchmarking against peer companies

3.3. Additional criteria to assess the creditworthiness of a counter-party without a rating are:

- Strong - A strong credit risk with low probability of default. Likely to be a strong Housing Association with capacity to meet short term and long term financial commitments. Slight sensitivity to longer tem macroeconomic external events or housing market conditions.
- Good – A good credit risk with a satisfactory probability of default. The counter-party is likely to be a good Housing Association or one of the top tier UK house building firms with a favourable financial position compared to its peers. Good financial characteristics: double digit and improving (on a like for like basis) net profit margins, tangible net assets (typically >£1,000m) & low gearing. No adverse financial trends identified with satisfactory levels of serviceability cover and leverage. Modest sensitivity to longer or medium term adverse macroeconomic events or housing market conditions.
- Satisfactory – A satisfactory credit risk with a fair probability of default, with any recognised weaknesses acceptable when viewed against the overall credit risk. The counter-party is likely to be an average large house builder or strong regional house building firm with a good financial positon compared to its peers. Entity will have a fair probability of default risk compared with similar sized companies. Acceptable levels of serviceability cover and leverage. Satisfactory financial characteristics: positive net

profit margin, positive net assets (typically £50m to £500m) acceptable level of gearing and a generally positive financial outlook. Capacity to meet medium and short term financial commitments considered fair with greater sensitivity to medium adverse external changes and market conditions.

- Weak – Marginal financial position with significant default risk. Established businesses or SPV with risk factors relating to low net capital resources, low equity contribution, no access to additional liquidity to fund cost overruns or other contingencies. Marginally acceptable capacity to meet financial commitments; susceptible to medium term adverse financial events or housing market conditions. More vulnerable to short term external events. Performance may be limited by one or more troublesome aspects or prospects of a worsening financial status. Financial characteristics include low margins, limited net assets and increased / high gearing.

- Unsatisfactory – A legal entity in financial difficulty with likely breach of covenants which are expected to be remedied. Worsening financial position evident in terms of deteriorating trends in net assets, net profitability and gearing. Financial condition is weak and capacity to repay has deteriorated. Whilst not in default at this point the counter-party is clearly suffering financial difficulties. Full repayment without steps such as realisation of collateral is still on balance anticipated. Probability of default within 12 months is high and expected between 20-30%. The GLA will not lend to financially unsatisfactory organisations.

4. Collateralisation

4.1. The level of collateralisation is based on what the GLA considers to be the Loss Given Default ("LGD"), which represents the amount of the loan that the lender could expect to lose in the event of default. This will involve an assessment of the amount that could be recovered from the project, the security offered, and also the bidder's balance sheet.

4.2. The GLA will always aim for a first charge over the assets offered as security but accepts that in some cases the involvement of other lenders will necessitate other arrangements. The GLA's main method of assessing collateral will be considering loan to value (LTV) ratios, of all secured borrowing in aggregate and the primacy of the charge. Banks, when assessing these types of loans normally consider a range of 60 to 80 percent of loan to value as an acceptable level of collateral. The proposed criteria are as follows:

- High Collateral – A LTV of up to 60% in total with a first charge or if GLA has a second charge a reasonable amount less than 60%;

- Normal Collateral – A LTV between 60% and 80% in total with a first charge or if GLA has a second charge towards the lower end of this range;

- Low Collateral – A LTV above 80% in total with a first charge or if GLA has a second around 75%.

4.3. The below is guidance with regards to the collateral categorisation:

- Where a proposition includes the offer of a first ranking fixed charge over land with a LTV ratio of up to 80% this shall be likely to be deemed to offer “Normal” collateral.
- Where a second charge is proposed around 75% LTV, or where a first change is offered but on a LTV above 80%, this would be likely to offer “Low” collateral.
- Where a proposition either a) offers commitments in addition to a first ranking fixed charge over land with a LTV ratio of between 60% and 80% (such as cost overrun guarantees, interest guarantees, performance bonds, parent company guarantees or personal guarantees), this shall be likely to be deemed to offer “High” collateral.

4.4. An offer of a parental guarantee will generally not be accepted as sole collateral, except in the case of a financially strong organisation offering such a guarantee to a joint venture, for a relatively short period of time.