Prudential Borrowing Code (PBC) for NHS Foundation Trusts

1 April 2009

Monitor
Independent Regulator of NHS Foundation Trusts

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Presented to Parliament pursuant to Section 41 of the National Health Service Act 2006.

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INTRODUCTION

1. Section 12 of the Health and Social Care (Community Health and Standards) Act 2003 required the Independent Regulator of NHS Foundation Trusts ('Monitor') to devise a code to determine a limit on the total amount of borrowing by NHS Foundation Trusts ('NHSFTs'). Section 41 of the National Health Service Act 2006 ('the 2006 Act') allows the Regulator to revise that code.

BACKGROUND

2. NHSFTs are granted financial and operational freedoms in line with the Government's policy of earned autonomy. The PBC provides a framework for NHSFTs to manage their capital positions with a greater degree of discretion, subject only to their ability to service the resulting obligations. This freedom enhances the ability of NHSFTs to respond quickly and effectively to the changing needs of patients by targeting capital where it will have the greatest positive impact on care. The PBC is intended to assist NHSFTs to maintain prudent capital positions relative to their revenues and costs.

3. NHSFTs are defined in legislation as public benefit corporations, with the principal role of providing goods and services for the purpose of the health service in England. They are independently managed organisations, with their own Board of Directors and Board of Governors. The vast majority of their revenue comes from taxpayers via the NHS commissioning process, and contracts between NHSFTs and other NHS bodies are legally binding. NHSFTs are able to borrow from commercial or public sector sources within limits set by Monitor through the PBC and as specified in their Terms of Authorisation.

4. The PBC has been drafted with regard to, amongst other things, generally accepted principles used by financial institutions to determine the amounts of loans to non-profit making bodies.

OBJECTIVE

5. The primary objective of the PBC is to enable NHSFTs to operate with an appropriate degree of independence while not compromising provision of required services. Any NHSFTs wishing to secure affordable debt financing from commercial sources, but without the backing of a Government guarantee or support, must prove its creditworthiness in a normal commercial sense.

6. To achieve this objective, the 2006 Act requires Monitor to consider generally accepted principles in revising the PBC. The experience in the United States is that non-profit hospitals rated BBB[1] or better (or the equivalent) by credit rating agencies have access to a wider range of affordable financing. The

[1] Moody's, Standard and Poor's and FitchRatings are the three top agencies that deal with credit ratings for the investment world. Ratings lie on a spectrum ranging from highest credit quality at one end to default at the other. Long-term credit ratings are denoted with a letter. "Aaa" or "AAA" is the highest credit quality and "C" or "D" (depending on the agency issuing the rating) is the lowest quality. Ratings that fall below "Baa" (Moody's) and "BBB" (S&P and FitchRatings) are considered to be non-investment grade.

code is therefore consistent with NHSFTs being at least as financially stable as the minimum investment grade category (i.e. BBB or equivalent). This is not to say that Monitor requires NHSFTs to obtain a particular credit rating, rather that BBB represents a minimum standard.

SETTING BORROWING LIMITS

7. Monitor sets the borrowing limit, the Prudential Borrowing Limit (PBL), based on the PBC and specifies the PBL in each NHSFT's Terms of Authorisation. The PBL is reviewed at least annually, and variations can be made upwards and downwards, as set out below.

8. For each NHSFT, the sum of borrowing from all sources must be within the PBL set by Monitor in its Terms of Authorisation. The Terms of Authorisation are published on Monitor's website.

9. An NHSFT's PBL consists of two components:

   i. The maximum cumulative amount of Long-Term Borrowing that enables the NHSFT to remain within the limit set by Monitor (see below for details); and

   ii. The amount of any approved Working Capital Facility.

10. Schedule 5 of the Terms of Authorisation will record the two components of the PBL. Long-Term Borrowing within the PBL will be treated as interchangeable (i.e. if a finance lease is paid off it may be replaced with new long-term debt, provided that the cumulative total does not exceed the PBL). This is in contrast to the Working Capital Facility, which is a stand-alone, short-term borrowing facility.

11. A breach of either component of the PBL will be a breach of an NHSFT's Terms of Authorisation and, if significant, may justify intervention by Monitor pursuant to section 52 of the 2006 Act (see paragraph 33 below).

Long-Term Borrowing

12. Following the adoption of International Financial Reporting Standards (IFRS) by NHSFTs from 1 April 2009, and the bringing of PFI funded schemes on-balance sheet, Long-Term Borrowing limits will be determined by a two tier system.

13. Long-Term Borrowing within the PBL includes finance leases and PFI financing that is classified as on-balance sheet, but does not include Public Dividend Capital (PDC), which is classified as equity for the purpose of the PBC.

14. Further information regarding on and off balance sheet treatment of loans and leases is included in the NHS Foundation Trust Financial Reporting Manual (FReM).

15. *Tier 1 Long-Term Borrowing limit ('Tier 1 limit')*
    A Tier 1 limit will be set by Monitor for NHSFTs based on their annual plans and in accordance with the ratios in f figure 1 below.

16. *Tier 2 Long-Term Borrowing limit ('Tier 2 limit')*
A Tier 2 limit is available, in appropriate circumstances, to accommodate affordable 'major investments' (as defined in the *Compliance Framework*) including PFI schemes.

17. When an NHSFT is planning a transaction that would exceed its Tier 1 limit, it is required to submit a request to Monitor for a Tier 2 limit, which, if approved, will replace the Tier 1 limit. Monitor will consider each application for a Tier 2 limit on a case-by-case basis.

18. Each request for a Tier 2 limit must:
    - relate to the replacement of an existing Tier 1 limit or an increase in an existing Tier 2 limit;
    - relate to a 'major investment' as defined in the *Compliance Framework (*except where the request is for an increase in an existing Tier 2 limit);
    - take account of all costs and related commitments of the proposed investment;
    - be within the Tier 2 cap, as defined in paragraph 25 below;
    - be supported by a full business case, taking account of risks and rewards and prepared in accordance with Monitor's publication *Risk Evaluation for Investment Decisions by NHS Foundation Trusts ('REID')*; and
    - be approved by the Board of the NHSFT.

19. In considering an application for a Tier 2 limit, Monitor will not approve or reject any investment funding scheme proposed by an NHSFT. That is the role of the Board of the NHSFT. Based on our review, Monitor will set a Tier 2 limit where appropriate and in relation to a specific request. If the project underpinning the request does not materialise, the Tier 2 limit will be withdrawn and the Long-Term Borrowing limit will revert to the Tier 1 limit.

20. Where an NHSFT has already entered into a binding commitment in relation to a PFI or an appropriate LIFT scheme as at 1 April 2009 and, due to adoption of IFRS, breaches its Tier 1 limit, the PFI scheme will be 'grandfathered' in. In such circumstances, a Tier 2 limit will be set by Monitor at the level of total NHSFT borrowing (including commitments) as at 1 April 2009.

PBC ratios and thresholds

21. NHSFTs must submit to Monitor an Annual Plan (pursuant to paragraph 27 of Schedule 7 of the 2006 Act). The content of this submission is set out in the *Compliance Framework*.

22. *Tier 1 limit - ratios and thresholds*
Monitor will set a Tier 1 limit for all NHSFTs using the ratios and thresholds shown in figure 1 below.

23. Based on the financial projections in its Annual Plan, each NHSFT, which did not have a Tier 2 limit in the prior year, applies for a Long-Term Borrowing limit such that none of the ratio tests in Tier 1 will be breached in any of the years covered by the Annual Plan. PBC ratio tests are applied to an NHSFT's Annual Plan to set the Long-Term Borrowing limit for each year. This limit applies for the whole year, subject only to material changes in the financial position of an NHSFT during the year.

Figure 1: Tier 1 PBC Ratio Tests*

	Tier 1 ratios	**Thresholds**
Minimum Dividend Cover	$\frac{\text{Revenue Available for Debt Service - Annual Interest}}{\text{Annual Dividend Payable on PDC}}$	>1x
Minimum Interest Cover	$\frac{\text{Revenue Available for Debt Service}}{\text{Maximum Annual Interest}}$	>3x
Minimum Debt Service Cover	$\frac{\text{Revenue Available for Debt Service}}{\text{Maximum Annual Debt Service}}$	>2x
Maximum Debt Service to Revenue	$\frac{\text{Maximum Annual Debt Service}}{\text{Revenue}}$	<2.5%

24. *Tier 2 cap - ratios and thresholds*
NHSFTs may apply for a Tier 2 limit on the basis of paragraph 18 above. The Tier 2 limit will be reviewed annually, based on the projections in the NHSFT's Annual Plan.

25. The Tier 2 limit will be subject to a maximum cap ('the Tier 2 cap'), determined through the ratio tests used in setting the Tier 1 limit, but with the thresholds shown in figure 2 below.

Figure 2: Tier 2 Cap Ratio Tests*

	Tier 2 ratios	**Threshold**
Minimum Dividend Cover	$\frac{\text{Revenue Available for Debt Service - Annual Interest}}{\text{Annual Dividend Payable on PDC}}$	>1x
Minimum Interest Cover	$\frac{\text{Revenue Available for Debt Service}}{\text{Maximum Annual Interest}}$	>2x
Minimum Debt Service Cover	$\frac{\text{Revenue Available for Debt Service}}{\text{Maximum Annual Debt Service}}$	>1.5x
Maximum Debt Service to Revenue	$\frac{\text{Maximum Annual Debt Service}}{\text{Revenue}}$	<10%

* See Appendix for definitions

26. An application for a new Tier 2 limit, or for an increase in an existing Tier 2 limit, should not exceed the Tier 2 cap.

Working Capital Facility

27. The limit on the Working Capital Facility will be set annually by Monitor, although variations can be requested within the year by an NHSFT or proposed by Monitor. The size of the facility will vary according to individual circumstances of each NHSFT. The Working Capital Facility is available, up to its own limit, for the purpose it was provided (i.e. for short-term cash flow management). It should not be treated as a fungible amount of prudential borrowing for other uses.

Reviews of PBL

28. The PBL will be calculated on an annual basis. At the same time as the financial risk ratings are published, Monitor will notify each NHSFT of any change in the PBL resulting from its review of the NHSFT's Annual Plan and will vary its Terms of Authorisation accordingly.

29. Monitor will also review each NHSFT on a quarterly basis, based on actual performance against its Annual Plan. If there is substantial variation between the Annual Plan and quarterly monitoring returns (e.g. a difference of 2 or more risk ratings), Monitor reserves the right to alter the PBL accordingly. The PBL may also be reviewed and revised between annual reviews if the NHSFT requests Monitor to do so or if, for some other reason, Monitor concludes that a material change in an NHSFT's circumstances warrants it. Reviews of the PBL other than the annual review, or at the request of an NHSFT (e.g. in accordance with paragraph 18), should not be considered normal business, and any such reviews will be conducted in consultation with the NHSFT.

30. If the circumstances of an individual NHSFT change materially, the NHSFT must notify Monitor promptly and Monitor may require submission of a revised financial model to consider whether to set a new PBL. A change is considered material if there is a revision of the NHSFT's projections that would cause a breach of the PBL or any of the Long-Term Borrowing ratios.

31. In certain exceptional circumstances (for example, but not limited to, a major renovation or redevelopment programme) an NHSFT may apply for a PBL which breaches one or more of the Long-Term Borrowing ratios. If agreed to by Monitor, this exceptional limit will continue for a period of time specified by Monitor or until the exceptional circumstances cease.

32. If the PBL is revised downward, it will not be varied below the sum of drawn down Long-Term borrowing and drawn down Working Capital Facility at that point in time, provided these borrowings were within the previous PBL. In cases where it can be demonstrated that commitment beyond this level of borrowing exists (for example, but not limited to, committed capital expenditure), Monitor may consider granting an exception. If Monitor considers that the level of borrowing is too high given the materiality of changed circumstances, Monitor and the NHSFT will consult on the remedial steps to be taken.

BREACH OF THE PBL

33. If borrowing exceeds either component of the PBL and is not authorised, the NHSFT will be in breach of its Terms of Authorisation. Breaches at any time must be immediately reported to Monitor, and Monitor may be satisfied that a breach of the PBL is a significant breach pursuant to section 52 of the 2006 Act. If so, the 2006 Act provides Monitor with a wide range of discretionary intervention powers to remedy the breach and/or its effect.

DIVIDEND PAYMENTS ON PDC

34. NHSFTs are required to pay an annual dividend on their PDC to the Department of Health at a rate to be determined from time-to-time by the Secretary of State. The rate is currently 3.5% per annum. This requirement is a condition of an NHSFT's Terms of Authorisation.

35. An NHSFT may seek Monitor's consent to defer such a dividend payment. It is the policy of Monitor that any deferral will be limited to one year's dividend, and Monitor will only give such consent in circumstances where:

    i. there is robust evidence that the NHSFT's financial position will return, within a period not exceeding one year, to a position where it can meet its financial obligations without breaching its PBL; and

    ii. a payment of the PDC dividend would have caused the NHSFT to:

        a. breach its PBL; or

        b. default on contractual obligations.

    It should be noted that, while Monitor may agree to such a deferral, ultimate consent must be sought from the Department of Health.

36. If such a deferral is permitted, the liability to make the payment accrues as an Accumulated Dividend. Moreover, the deferral request will be viewed by Monitor as evidence of a potentially serious issue within the finances and/or management of the NHSFT which could merit investigation and intervention under the terms of section 52 of the 2006 Act. However, failure to pay the PDC dividend or exceeding the PBL is not automatically considered indicative of insolvency.

APPENDIX: DEFINITIONS FOR THE PURPOSES OF THE PBC

TERM	DESCRIPTION
Accumulated Dividend	Any unpaid PDC dividend
Annual Debt Service (ADS)	On a Financial Year basis, all interest and principal payable on Long-Term Borrowing as defined herein, whereby principal payable should be the 'net repayment' of long-term loan principal; discounting; rollovers of existing long-term loans; repayment of short-term bridging loans and similar repayments that do not result in ongoing long-term loan repayment commitments, including finance leases and any similar items, and including the imputed finance charge and capital portions of Unitary Payments for on-balance sheet PFIs. Annual Debt Service does not include interest payable or principal repayments on amounts drawn down under a Working Capital Facility, nor does it include interest payable or principal repayments resulting from the rollover of loans, bridging loans or loans scheduled to be repaid in full in the subsequent twelve months.
Annual Interest (AI)	On a Financial Year basis, all interest payable on Long-Term Borrowing, including finance leases and similar items, as well as the imputed finance charge portion of Unitary Payments for on-balance sheet PFIs. Annual Interest does not include any portion of Unitary Payments for off-balance sheet PFIs; neither does it include interest payable on amounts drawn down under a Working Capital Facility.
Annual Plan	Annual submission by NHSFTs of plans at 31 May (or as amended), including three year financial projections and investment strategies.
Financial Year	The NHSFT's financial year (i.e. 1 April to 31 March).
Long-Term Borrowing	All outstanding borrowing (e.g. borrowings from the Foundation Trust Financing Facility, commercial loans), including all group borrowings that are normally reported on the balance sheet per the FReM; finance leases and similar items; on-balance sheet PFIs; and any Accumulated Dividend. This excludes amounts drawn down from a Working Capital Facility.
Maximum Annual Debt Service	On a forecast basis, the largest ADS.
Maximum Annual Interest	On a forecast basis, the largest AI.
Prudential Borrowing Code	Code provided by Monitor to determine the limit

(PBC)	on the total amount of borrowing of an NHSFT.
Prudential Borrowing Limit (PBL)	The maximum amount of borrowing (including finance leases and similar items, and including on-balance sheet PFI schemes) that an NHSFT can have outstanding at any time under the PBC. The PBL consists of two components: (i) the maximum Long-Term Borrowing, as defined herein, allowed on a forecast basis; and (ii) the agreed-upon Working Capital Facility. Neither of these should be breached.
Public Dividend Capital (PDC)	PDC is the amount of all assets (except for assets in the course of construction and donated assets), less current liabilities, provisions for liabilities and charges and other borrowing. See FReM for more information.
PDC Dividend Rate	The Dividend Rate on PDC as set from time to time by HMT. Currently 3.5% per annum. See FReM for more information regarding calculation.
Revenue	Income from activities and other operating income over the financial year, excluding exceptional transactions (e.g. asset disposals).
Revenue Available for Debt Service	For each Financial Year: Surplus (Deficit) for the Financial Year prior to Dividend Payable + Depreciation + Annual Interest + Interest on any Working Capital Facility. This should exclude exceptional transactions.
Working Capital Facility	An irrevocable borrowing facility repayable in the short-term (within 24 months) that an NHSFT may draw from on a temporary basis to smooth cash flow.

FINANCIAL RATIOS	DESCRIPTION
Minimum Dividend Cover	$\dfrac{\text{Revenue Available for Debt Service - Annual Interest}}{\text{Annual Dividend Payable on PDC}}$
Minimum Interest Cover	$\dfrac{\text{Revenue Available for Debt Service -}}{\text{Maximum Annual Interest}}$
Minimum Debt Service Cover	$\dfrac{\text{Revenue Available for Debt Service -}}{\text{Maximum Annual Debt Service}}$
Maximum Debt Service to Revenue	$\dfrac{\text{Maximum Annual Debt Service -}}{\text{Revenue}}$

DIVIDEND, INTEREST RATES AND BORROWING TERMS	DESCRIPTION
Interest Rate Assumptions for Projected Borrowings	If borrowings have been contracted with a specific interest rate, then this should be used, otherwise the current rate for UK gilts for the maturity of the loan + 1% margin should be used as a safe harbour.
Borrowing Term	The average life of the borrowing if being used for capital purposes should not exceed the projected average life of the facility being financed. In the absence of a specific borrowing programme a reasonable maturity should be assumed (e.g. 10 years).

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Publication code: IRG 04/09