greater WELLINGTON
REGIONAL COUNCIL

Centralised Borrowing Vehicle

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FOR FURTHER INFORMATION

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1. Introduction

Local Government (LG) will be undertaking a large amount of infrastructure projects over the next few years which are largely expected to be funded from debt. It is estimated that these additional borrowings could be in the order of $30 billion over the next 10 years, which is far in excess of the current level of borrowings for LG. This significant increase in borrowings will provide both challenges and opportunities for LG. If LG is unable to access the funds required or access the funds at competitive rates it may negatively impact on LG's ability to undertake a number of their planned projects.

Currently LG borrows money from three main sources:

- Banks
- Wholesale issues by private placement with institutional investors
- Retail issues to the public.

LG is not permitted to borrow funds in currencies other than New Zealand dollars.

The purpose of this paper is to consider a number of options to improve LG's ability to access the funds they required.

2. Current situation

Based on individual Annual Reports, current council borrowings are in the order of $4.5 billion. The majority of this has been funded from the wholesale market via bonds, Floating Rate Notes (FRN's) and commercial paper. Only a small amount has been funded from the banks. Until recently there has been very few retail issues to the public due to the constraints provided by legislation, which have now been partly eliminated. The recent Securities (Local Authority Exemptions) Bill was passed in 2008 which allowed councils to issue debt securities to the retail market without a full prospectus.

However, an Investment Statement must still be prepared with full financial statements not more than nine months old. This requires councils to prepare six monthly financial statements to enable them to issue on a 12 month basis.

The majority of debt issued by LG is in relatively small quantities, usually below $100 million, and issued across a number of different maturity dates. This provides a problem for those investors who require liquidity and the ability to buy and sell debt securities on a regular basis. Individual councils are unlikely by themselves, to provide debt issues of sufficient size at specific maturity dates to be able to provide the required liquidity.

In addition, the pricing of LG debt, when compared with central government, appears high. For example central government five year bonds are priced at 4.60% compared with the LG equivalent debt at 7.05%.

There is a variety of security structures used by LG for their borrowings although the most common structure is a debenture trust deed with a charge over rates. Some councils have a credit rating, but a number do not. There is a wide variety in the level of debt held by councils from zero up to $350 million, although a number of councils with debt also have significant investments. Overall the level of debt held by councils is not high when compared with their asset and rating base and with the corporate sector. The level of expertise in respect of debt and treasury matters within LG is variable, some have a lot of expertise, others less so.

3. Future borrowings

It is estimated that over the next 10 years or so LG will require an additional $30 billion of borrowings to fund their activities and infrastructure projects. This is a very large amount when compared with the current level of borrowings of $4.5 billion. Even if the $30 billion is significantly overstated, it is evident that there is going to be a large increase in LG's borrowing requirements over and above the current borrowings. This poses a serious challenge for LG to be able to fund this increasing debt efficiently and effectively. As noted earlier LG is not permitted to borrow in foreign currencies, this limits their ability to access a much deeper and wider investor market and arguable better priced funding market, as the lender would have to lend to LG in New Zealand dollars.

Therefore, it is assumed that for the purposes of this paper the offshore debt markets are not available to LG.

4. Rating Agencies

A number of councils in New Zealand have a credit rating, usually from Standards and Poor's, which range from AAA to A. There is a view in the market that the rating agencies have given LG entities a lower rating than would be expected, given that LG has the power to rate and the legislative power to enforce rating default. However, it is unlikely that they are going to change their approach in the near future especially with the current financial crisis.

However, any entity wishing to access the debt markets will need a credit rating to obtain competitive pricing and volume.

5. Future LG funding sources

5.1 Councils borrow from the Government

Instead of issuing debt to the wholesale, bank or public markets, LG could borrow from central government in a similar manner to District Health Boards. In effect LG would become part of central government's borrowing programme.

While this may have advantages in simplicity, pricing and liquidity, there are a number of issues with it, in particular:

- It may negatively impact on central government's own debt programme
- Councils may become beholden to central government for its funding, thus losing some of its autonomy.

5.2 Crown guarantee on LG debt

Currently, the Crown (for a fee) guarantees certain bank deposits and borrowings which are in response to the current financial crisis.

If LG debt was guaranteed by the Crown, then this would lower borrowing margins to LG (subject to any fee charged by the Crown) but it would not solve the issue of a lack of liquidity.

In addition while the Crown is currently giving a guarantee to financial institutions this is seen as a short term solution to the current financial crisis.

However, investors are not overly concerned with the risk of default by LG as they often have a charge over the rates of the individual council if there is default. Therefore, it is unlikely that a Crown guarantee would significantly improve the situation that LG faces when raising debt.

5.3 Centralised debt vehicle to issue retailable LG debt

Around 2001 the Local Government Finance Corporation (LGFC) was set up through Civic Assurance to provide a centralised vehicle for LG borrowings. The other parties involved were the BNZ, Deutsche Bank and ABN AMRO Craigs.

Unfortunately, LGFC was not successful. There were a number of reasons, the main ones would appear to be:

- Some councils could achieve better pricing on an individual basis rather than through LGFC
- Some banks and brokers with a wider distribution capacity were not involved
- LGFC did not have a credit rating
- Whilst retailable, the bonds were not extensively marketed.

Despite this failure a centralised borrowing vehicle (CBV) issuing LG debt would appear to satisfy the major issues facing LG, in particular:

- Providing sufficient liquidity and volume for the market to attract investors
- Allows issues of size to be targeted at specific maturities
- Providing better pricing for LG
- Properly marketed to the retail market a single prospectus would be easier to maintain on a continuous basis.

However, for a CBV to be successful and to avoid the problems faced by LGFC there are a number of matters which need to be resolved:

- The CBV needs to have a credit rating closely aligned with the Crown

- The CBV needs to be managed and operated by people with a good understanding of the New Zealand/International debt and capital markets including the ability to market the debt to both the wholesale and retail markets

- Individual councils must have the ability to opt in or out of issuing through CBV as this would provide autonomy for the councils and ensure that the pricing offered by the CBV is competitive

- A council with a higher credit rating should achieve better pricing with the CBV than a council with a lower or no credit rating

- Brokers and banks (the organisations which will sell the debt) need to be properly incentivised

- The debt issued by CBV must be retailable to smaller investors thus opening up another market for LG and providing the smaller investor with a secure investment

- Whether the CBV would provide a market for its debt by offering continuous two-way pricing.

Regardless of the ownership of the CBV it is likely that the Crown will have to be involved, probably in the form of credit support or capital. It is unlikely that LG will be willing to provide sufficient capital to CBV to enable it to obtain a credit rating close to the Crown's.

6. How would it work?

A council needing to raise debt would approach CBV with their requirements, ie, term and quantity. It is likely that the term would need to fairly standard, say 3, 5, 7 or 10 years. CBV would offer the council the debt at their standard conditions and offer an interest rate margin over the relevant reference rate. Upon acceptance the monies would be lent to the council, whose obligation in respect of the debt is with CBV.

CBV in turn would fund their requirements from existing issues, commercial paper or their own bank funding lines. Alternatively, the CBV could plan a debt issue and gauge interest from councils and, assuming there was sufficient demand, issue the debt to the market. The market would be lending to the CBV and not the councils, therefore the credit rating of CBV must be close to or the same as the Crown's rating.

The debt should be listed with the NZSX to provide a vehicle for trading of the debt.

7. Volume

To be successful the CBV will need to issue debt in sufficient volumes in each of the maturities to provide sufficient liquidity for the market. Without this liquidity, the CBV will not achieve its objective, particularly in the area of pricing.

Issues will need to be in the order of $200 million to $500 million to provide sufficient volume for the debt to be easily traded by investors.

These amounts are for individual issues, the total volume of debt outstanding by the CBV will be far larger.

8. Other matters

There have been a number of discussions with the Crown and other interested parties regarding a CBV. The Treasury is involved and supportive of the concept. The NZSX, following the Crown's job summit, has also written a paper on the matter. It is likely that the proposal will move to the next stage and be considered by Cabinet.

9. Conclusions and next steps

LG over the next few years will be borrowing significant debt in excess of their current levels. It will be difficult for a number of individual councils to maintain competitive pricing and term of their debt.

A CBV, properly structured and resourced, would assist both LG and the investors (both retail and institutional) meeting their needs. However, this will need careful structuring and involvement of the relevant parties to avoid making the same mistakes as with LGFC.

The Government, through Treasury, is currently trying to determine the most effective process to undertake the CBV initiative. It is likely that in supporting the initiative, Treasury see themselves as a partner to the process, but with Local Government New Zealand taking the lead role. Consequently a forum/organisation within the local government sector needs to lead the CBV initiative. This forum may be Local Government New Zealand. Once this organisation is mandated to assume the lead advocacy role then the process of determining the most appropriate structure can get fully underway.

To achieve this it is recommended that a working group of people with experience and expertise in the New Zealand debt market is formed under the auspices of Local Government New Zealand.

10. Recommendations

That the Regional Affairs Committee:

1. ***Receives*** *the report*

2. ***Notes*** *its contents*

3. ***Requests*** *that Local Government New Zealand form a working group to progress this matter.*

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