PROPOSED LOCAL GOVERNMENT FUNDING AGENCY SCHEME

INFORMATION MEMORANDUM

PART A – INTRODUCTION AND PURPOSE

Purpose of Information Memorandum

1. This Information Memorandum provides a description of a funding structure for local authorities (LGFA Scheme), which was designed to enable participating local authorities (Participating Local Authorities) to borrow at lower interest margins than they would otherwise pay.

2. The purpose of this Information Memorandum is to provide information to supplement any consultation materials prepared by local authorities consulting on whether to participate in the LGFA Scheme.

3. This Information Memorandum is divided into three parts:

   a) This Part A (Introduction and Purpose), which sets out the purpose of the Information Memorandum and provides some background on the purpose of, and rationale for, the LGFA Scheme.

   b) Part B (How the LGFA Scheme Works), which sets out the characteristics of the LGFA Scheme, and the transactions that Participating Local Authorities will be entering into as part of their participation in the LGFA Scheme.

   c) Part C (Local Authority Costs and Benefits), which sets out the costs and benefits to individual local authorities of participating in the LGFA Scheme.

Origin of the LGFA Scheme

4. The LGFA Scheme was developed by a group of New Zealand local authorities and the Crown on 1 December 2011, to enable local authorities to borrow at lower interest margins than would otherwise be available. Currently there are 54 participating Council's and at 31 January 2018 the LGFA has lent $7.5 billion to the local authority sector. The development of the LGFA involved:

   a) undertaking a detailed review and analysis of:

      i) the then current borrowing environment in which New Zealand local authorities borrow; and

      ii) centralised local authority debt vehicle structures that have been developed offshore to successfully lower the cost of local authority borrowing;

b) using this review and analysis to develop a funding structure (the LGFA Scheme), which was anticipated to deliver significant benefits to New Zealand local authorities;

c) confirming with rating agencies that the proposed LGFA Scheme could achieve a high enough credit rating to deliver the anticipated benefits;

d) obtaining formal central government support to facilitate establishment of the LGFA Scheme.

Rationale for LGFA Scheme

New Zealand Local Authority debt market

5. At the time the LGFA Scheme was developed, New Zealand local authorities faced a number of debt related issues.

6. First, local authorities had significant existing and forecast debt requirements. Councils 2009-2019 long-term plans indicated that local authority debt would double over the next five years to over $9 billion.

7. Secondly, pricing, length of funding term and other terms and conditions varied considerably across the sector and were less than optimal. This was due to:

   a) Limited debt sources – Local authorities' debt funding options were limited to the banks, private placements and wholesale bonds (issuance to wholesale investors), and, to a lesser extent, retail bonds. Increasing local authority sector funding requirements and domestic funding capacity constraints were likely to further negatively impact pricing, terms and conditions and flexibility of local authority sector debt.

   b) Fragmented sector – There were 78 local authorities. Individually, a significant proportion of these local authorities lacked scale – the 10 largest accounted for ~68% of total sector borrowings. The remaining 68 councils had 32% of sector borrowings.

   c) Regulatory restrictions – Offshore (foreign currency) capital markets were closed to local authorities with the exception of Auckland Council and the compliance process for local authority retail bond issuance was burdensome and generally restricted issuance to a six month window.

Addressing the local authority debt issues

8. Each of these issues needed to be addressed to rectify this situation. This was not likely to happen without an intervention like the LGFA Scheme for the following reasons:

   a) The New Zealand debt markets (at least in the foreseeable future) were likely to maintain the status quo.

   b) Individually, local authorities were not be able to attain significant scale.

c) At a sector level it might have been possible to address the issue regarding regulation, but regulators were likely to remain reluctant to significantly ease restrictions on financial management across the sector without gaining significant comfort as to the sophistication of the financial management of all local authorities. Even if this issue was addressed by regulators, this change alone would have been insufficient to provide a major step change.

9. The LGFA Scheme was developed because of the homogenous nature of local authorities; the large sector borrowing requirements and the high credit quality / strong security position (i.e. charge over rates) of local authorities. This created the opportunity for a centralised local authority debt vehicle to generate significant benefits.

10. There were numerous precedents globally of successful vehicles that pooled local authority debt and funded themselves through issuing their own financial instruments to investors. Such vehicles achieved success through:

    a) "Credit rating arbitrage" – Attaining a credit rating higher than that of the individual underlying assets (local authority borrowers) and therefore being able to borrow at lower margins.

    b) "Economies of scale" – By pooling debt the vehicles could access a wider range of debt sources and spread fixed operating costs, thereby reducing the $ cost per $ of debt raised.

    c) "Regulatory arbitrage" – The vehicles could receive different regulatory treatment than the underlying local authorities, improving their ability to efficiently raise debt, e.g. through access to offshore foreign currency debt markets.

11. The offshore precedents were typically owned by the local authorities in the relevant jurisdiction (often with central government involvement), and that is what was proposed here through the LGFA Scheme.

12. The LGFA Scheme has now been successfully operating for six years. It has exceeded the original lending and profit targets that were forecast in 2011.

PART B – HOW THE LGFA SCHEME WORKS

Basic structure of the LGFA Scheme

13. The basic structure of the LGFA Scheme is that a company has been established that borrows funds and lend them on to local authorities at lower interest margins than those local authorities would pay to other lenders.

New Zealand Local Government Funding Agency Limited

14. The company that lends to local authorities under the LGFA Scheme is called the New Zealand Local Government Funding Agency Limited (LGFA). It is a limited liability company, and its shares are held entirely by the Crown and by local authorities.

15. 20% of the shares in the LGFA are held by the Crown and the remaining 80% by 30 individual local authorities. Thus the LGFA is a Council Controlled Trading Organisation (CCTO).

16. The LGFA was established solely for the purposes of the LGFA Scheme, and its activities are limited to performing its function under the LGFA Scheme.

17. 30 local authorities (Principal Shareholding Local Authorities) hold those shares that are not held by the Crown. The Principal Shareholding Local Authorities contributed capital and, as compensation for their capital contribution, receive a predetermined return on this capital. However, the over-arching objective is that the benefits of the LGFA Scheme are passed to local authorities as lower borrowing margins, rather than being passed to shareholders as maximised profits.

Design to minimise default risk

18. One of the features that is critical to the LGFA Scheme delivering its benefit to the sector is the achievement of a high credit rating for the LGFA. Currently it is rated 'AA+' long term from Standard and Poor's, which enables it to achieve the credit rating arbitrage referred to in paragraph 10(a). Consequently there are a number of features of the LGFA Scheme that are included to provide the protections for creditors that rating agencies require before agreeing to a high credit rating. These features are described in paragraphs 19 to 52 below.

19. Before agreeing to a high credit rating, rating agencies will consider the risks of both short term and long term default. Short term default is where a payment obligation is not met on time. Long term default is where a payment obligation is never met. In many cases short term default will inevitably translate into long term default, but this is not always the case – a short term default may be caused by a temporary shortage of readily available cash.

Features of the LGFA Scheme designed to reduce short term default risk

20. When a local authority borrows, the risk of short term default, although low, is probably significantly higher than its risk of long term default. In the long term it can assess and collect sufficient rates revenue to cover almost any shortfall, but such revenue cannot be collected quickly. Consequently, there is a risk that inadequate liability and revenue management could lead to temporary liquidity problems and short term default.

21. The principal asset of the LGFA will be loans to participating local authorities, so such temporary liquidity risks are effectively passed on to the LGFA. Consequently, the rating agencies look for safeguards to ensure that liquidity problems of a Participating Local Authority will not lead to a default by the LGFA.

22. There are two principal safeguards that the LGFA has in place to manage short term default (liquidity) risk:

a) It holds cash and other liquid investments (investments which can be quickly turned into cash). As at 30 June 2017 LGFA held $311 million of cash and liquid investments.

b) It currently holds a $1 billion borrowing facility with central government that allows it to borrow funds from central government if required.

23. It is expected that these safeguards will sufficiently reduce any short term default risk.

Features of the LGFA Scheme designed to reduce long term default risk

24. There are a number of safeguards that the LGFA has in place to manage long term default risk, the most important of which are set out below:

a) The LGFA requires all local authorities that borrow from it to secure that borrowing with a charge over that local authority's rates and rates revenue (Rate Charge).

b) The LGFA maintains a minimum capital adequacy ratio.

c) The Principal Shareholding Local Authorities have subscribed for $20 million of uncalled capital in an equal proporations to their paid up equity contribution.

d) As at 31 January 2018, 45 Participating Local Authorities (Guaranteeing Local Authorities) guarantee the obligations of the LGFA.

e) Guaranteeing Local Authorities commit to contributing additional equity to the LGFA if there is an imminent risk that the LGFA will default.

f) The LGFA hedges any exposure to interest rate and foreign currently fluctuations to ensure that such fluctuations do not significantly affect its ability to meet its payment obligations.

g) The LGFA puts in place risk management policies in relation to its borrowing and lending designed to minimize its risk. For example, it imposes limits on the percentage of lending that is made to any one local authority to ensure that its credit risk is suitably diversified.

h) The LGFA ensures that its operations are run in a way that minimises operational risk.

i) Additional detail in relation to the features referred to in paragraphs 24(a) to 24(e) is set out below.

Rates Charge

25. All local authorities borrowing from the LGFA are required to secure that borrowing with a Rates Charge.

26. This is a powerful form of security for the LGFA, because it means that, if the relevant local authority defaults, a receiver appointed by the LGFA can assess and collect sufficient rates in the relevant district or region to recover the defaulted payments. Consequently, it significantly reduces the risk of long term default by a local authority borrower.

27. From a local authority's point of view it is also advantageous, because, so long as the local authority adheres to LGFA's financial covenants, it is entitled to conduct its affairs without any interference or restriction. This contrasts with most security arrangements, which involve restrictions being imposed on a borrower's use of its own assets by the relevant lender.

Minimum capital

28. One important factor in LGFA obtaining its high credit rating (AA+ from S&P and Fitch) is the LGFA having a minimum capital adequacy ratio (a ratio that measures the relative amounts of equity and debt-based assets that an entity has). A strong credit rating is important, because it provides an indication of the ability of the LGFA to ultimately repay all of its debts.

29. The minimum capital adequacy ratio requirement is an amount equal to at least 1.6% of its total assets. As at June 2017 the actual ratio was 2.19%.

Sources of equity for capital adequacy purposes

30. The equity held by the LGFA to ensure that it meets its minimum capital adequacy ratio requirement comes from two sources. First, the Crown and the Principal Shareholding Local Authorities contributed $25 million of initial equity as the issue price of their initial shareholdings. Retained earnings have seen the value of this equity rise to $53.86 million as at 30 June 2017. Secondly, each Participating Local Authority must, at the time that it borrows from the LGFA, contribute some of that borrowing back as equity. This source of equity is called borrower notes.

31. The way the borrower notes works is that, whenever a Participating Local Authority borrows, it does not receive the full amount of the borrowing in cash. Instead, a small percentage of the borrowed amount is invested by the local authority into borrower notes. LGFA pay interest on borrower notes. That percentage is 1.6% of the amount borrowed.

32. Borrower notes are repaid when the borrowing is repaid, so, in effect, the amount that must be repaid equals the cash amount actually advanced.

33. Borrower notes are convertible in some circumstances into shares in the LGFA.

34. To illustrate with an example, if a local authority borrowed $1,000,000 for five years from the LGFA, it would receive $984,000 in cash and $16,000 of Borrower Notes. At the end of the five years, it would repay $1,000,000, but would simultaneously redeem its Borrower Notes of $16,000, meaning its net repayment was equal to the $984,000 it initially received in cash.

35. A return is paid on the Borrower Notes, However, while it is anticipated that this return will be paid, it is paid at the discretion of the LGFA.

36. There is some additional risk to Participating Local Authorities from this arrangement, because redemption of the Borrower Notes will only occur if the LGFA is able to pay its other debts. For example, if at the end of five years, the LGFA was insolvent, the local authority would have to repay $1,000,000, but would not receive its $16,000 back for redeeming its Borrower Notes. To date, LGFA have fully repaid all borrower notes that have matured.

Guarantee

37. Most Participating Local Authorities entered into a guarantee when they join the LGFA Scheme (Guarantee). Under the Guarantee the Guaranteeing Local Authorities guarantee the payment obligations of the LGFA.

38. The purpose of the Guarantee is to provide additional comfort to lenders (and therefore credit rating agencies) that there will be no long term default, though it may also be used to cover a short term default if there is a default that cannot be covered using the protections described in paragraphs 20 to 23 above, but which will ultimately be fully covered using the rates charge described in paragraphs 25 to 27. The Guarantee allows the LGFA to draw upon the resource of all guaranteeing Local Authorities to avoid defaults.

LGFA Guarantee

39. The Guarantee will only ever be called if the LGFA defaults. Consequently, a call on the Guarantee will only occur if the numerous safeguards put in place to prevent an LGFA default fail. This is highly unlikely to happen.

40. If any such default did occur, and the Guaranteeing Local Authorities were called on under the Guarantee they could potentially be called on to cover any payment obligation of the LGFA. Such payment obligations may (without limitation) include obligations under the following transactions:

    a) A failure by the LGFA to pay its principal lenders.

    b) A failure by the LGFA to repay drawings under the liquidity facility with central government.

    c) A failure by the LGFA to make payments under the hedging transactions referred to in paragraph 24(f).

Guarantee risk shared

41. There is a mechanism in the LGFA Scheme to ensure that payments made under the Guarantee are shared between all Guaranteeing Local Authorities. The proportion of any payments borne by a single Guaranteeing Local Authority is based on the annual rates revenue in its district or region.

Rates Charge

42. All particiapting Local Authorities must provide a Rates Charge to secure their obligations under the Guarantee.

Benefits of being a Guaranteeing Local Authority

43. Participating Local Authorities that are not Guaranteeing Local Authorities may only borrow up to $20,000,000 and pay a higher interest margin for their borrowing.

44. Therefore, Guaranteeing Local Authorities have the benefit of not having this low limit on borrowing, and paying lower funding costs.

Additional equity commitment

45. In addition to the equity contributions made in conjunction with borrowing, all Guaranteeing Local Authorities are required to commit to contributing equity if required under certain circumstances. It is expected that calls on any such commitments will be limited to situations in which there is a risk of imminent default by the LGFA.

46. A call for additional equity contributions will only be made if calls on the uncalled Capital and on the Guarantee will not be sufficient to eliminate the risk of imminent default by the LGFA. Consequently, the factors that limit the risk in relation to the Cross Guarantee also apply here.

47. All participating Local Authorities are required to provide a Rates Charge to secure their obligations to contribute additional equity.

Characteristics designed to make the LGFA Scheme fair for all Participating Local Authorities

48. The principal risk involved with the LGFA Scheme is that Participating Local Authorities will default on their payment obligations. The greater this risk is, the less attractive participation in the LGFA Scheme is for all Participating Local Authorities.

49. The Participating Local Authorities do not create this risk in equal amounts. There are some that carry a greater default risk than others, and therefore contribute disproportionately to the overall risk in the LGFA Scheme. Those local authorities are also the local authorities that would be likely to pay the highest interest margins if they borrowed outside the LGFA Scheme, and so potentially benefit the most from the LGFA Scheme.

50. To avoid, or at least minimise, what is effectively cross subsidisation of the higher risk local authorities by the lower risk local authorities, different interest margins are paid by different local authorities when they borrow from the LGFA, with margins based on if a local authority has an external credit rating and what the actual external credit rating is. For example a “AA” rated local authority will pay a slightly lower interest margin than a “AA-“ rated local authority. A unrated local authority will pay a slightly higher margin than a rated local authority.

Summary of transactions a Local Authority will enter into if it joins the LGFA Scheme

51. If a Local Authority joins the LGFA Scheme as a Guaranteeing Local Authority, it will:

a) subscribe for Borrower Notes (see discussion in paragraphs 32 to 36);

b) enter into the Guarantee (see discussion in paragraphs 38 to 44 above);

c) commit to providing additional equity to the LGFA under certain circumstances (see discussion in paragraphs 47 to 51 above); and

d) provide a Rates Charge to secure its obligations under the LGFA Scheme (see discussion in paragraphs 25 to 27, and 42 above).

PART C – LOCAL AUTHORITY COSTS AND BENEFITS

Benefits to local authorities that borrow through the LGFA Scheme

52. It is anticipated that the LGFA will be able to borrow at a low enough rate for the LGFA Scheme to be attractive because of the three key advantages the LGFA will have over a local authority borrower described in paragraph 10. That is – exploiting a credit rating arbitrage, economies of scale and a regulatory arbitrage.

53. In addition, the LGFA will provide local authorities with increase certainty of access to funding and terms and conditions (including the potential access to longer funding terms. LGFA currently offers borrowing terms out to 15 years.

54. The potential savings for a local authority in terms of funding costs will depend on the difference between the funding cost to that local authority when it borrows from the LGFA and the funding cost to the local authority when it borrows from alternative sources (Refer to page 3 last paragraph). This difference will vary between local authorities.

55. The funding costs each local authority pays when it borrows from the LGFA will be affected by the following factors, some of which are specific to the local authority:

a) the borrowing margin of the LGFA;

b) the operating costs of the LGFA;

c) whether a local authority has an external credit rating

Costs to local authorities that borrow through the LGFA Scheme

56. The costs to Participating Local Authorities as a result of their borrowing through the LGFA Scheme take two forms:

    a) First, there are some risks that they will have to assume to participate in the scheme, which create contingent liabilities (i.e. costs that will only materialise in certain circumstances).

    b) Secondly, there is a minor cost associated with the Borrower Notes.

Risks

57. The features of the LGFA Scheme described above which are included to obtain a high credit rating are essentially steps that remove risk from lenders to make their residual risk low enough to justify the high credit rating. These features remove risk, in part, by transferring it to Participating Local Authorities.

58. These risks are that:

    a) in the case of Guaranteeing Local Authorities, a call is made under the Guarantee (see discussion in paragraphs 37 to 41 above);

    b) in the case of Guaranteeing Local Authorities, a call is made for a contribution of additional equity to the LGFA (see discussion in paragraphs 45 to 47 above); and

    c) in the case of all Participating Local Authorities, the LGFA is not able to redeem their Borrower Notes (see discussion in paragraphs 32 to 36).

59. Each of these risks is discussed in some detail in the paragraphs indicated next to the relevant risk. For the reasons set out in those discussions, it is anticipated that each of the risks is low.

Cost of Borrower Notes

60. As discussed in paragraphs 32 to 36, all Participating Local Authorities are required to invest in Borrower Notes when they borrow from the LGFA. This carries a small cost, because the investment in Borrower Notes is funded by borrowing from the LGFA, and the cost of this funding will be slightly higher than the return paid on the Borrower Notes.

61. As noted in paragraph 36, while it is the intention for the LGFA to always pay interest on the Borrower Notes, such payments are at the LGFA's discretion so, in some situations, those payments may not be made.