Regulatory Impact Statement: enhancing local government borrowing options

Regulatory Impact Statement

Enhancing Local Government Borrowing Options

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by The Treasury.

In the Treasury's view the investigations, analysis and consultations completed to date are sufficient for Cabinet to make decisions on whether and how to enhance local government borrowing options including a decision on whether to exempt Auckland Council from the current law preventing New Zealand local authorities from borrowing in foreign currencies.

In the Treasury's view none of the options considered is likely to have the effects that government has said will require a particularly strong case before regulation is considered. In particular none of them would be likely significantly to:

- impose additional costs on businesses;
- impair private property rights, market competition, or the incentives on businesses to innovate and invest, or
- over-ride fundamental common law principles (as referenced in Chapter 3 of the Legislation Advisory Committee Guidelines).

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The Treasury

Signature of person Date

Introduction and background

1. This Regulatory Impact Statement (RIS) provides an analytical overview of options about how local authorities may be able to borrow more cost effectively than they are currently able to. These options (apart from the status quo) depend on taking advantage of economies of scale that are afforded by acting collectively rather than individually. The option that appears to offer the greatest net benefits is to establish a single local-government debt vehicle.

2. The RIS also describes the additional option of allowing the new Auckland Council to borrow in foreign currencies as a means to address its forecast large borrowing needs that a new single local-government debt vehicle will not be able to accommodate. This is assessed against the status quo laid down in the Local Government Act 2002 forbidding all local authorities from borrowing in foreign currencies.

3. Discussions among local government representatives, Treasury and the Reserve Bank in 2008 centred on what might be constraining a perceived missed opportunity – namely realising for councils, in the form of cheaper borrowing rates, the benefit of the very low credit risk they are able to offer. It was concluded that the main reason for failure to grasp this opportunity was the difficulty for numerous local authorities to coordinate effectively.

4. The initial review identified that the market for local authority debt was fragmented: eighty issuers, and several hundred mainly-small issues of debt. Co-ordination to concentrate issuance would improve the overall market for local authority debt and lead to a more efficient solution both to issuers and investors, and to New Zealand's capital market generally. Possible alternative options are described on pages 5-8.

5. Since 2009 a Steering Group of local and central government officials has been running a process to try to solve this problem and determine the merits of different options. A particular option of interest was establishing some form of single local-government debt vehicle.

6. This process included commissioning consultants to investigate the feasibility and desirability of such a co-operative among councils and what design would work best among a range of options. The consultants' analysis found significant cost savings are possible. Working with the Steering Group they identified a preferred model in which a single vehicle would issue bonds to wholesale and retail investors and on-lend the funds raised to participating councils to meet their infrastructure and other capital investment needs.

7. The Capital Markets Development Taskforce supported further work on a single debt vehicle for local authorities. It recommended that central government continue to support and coordinate the development of a local government bond bank until it was firmly established. It also found that, from a capital-markets perspective, a deep and liquid market in standardised local authority bonds would have benefits for both wholesale and retail investors, and for capital-market development as a whole.

8. On the basis of the above analysis and recommendation, the government approved $5 million of funding in Budget 2010 for a central government contribution to help establish a single debt vehicle for local government borrowing.

9. The CEOs and CFOs of nine of the larger local authorities are committed to supporting the creation of the necessary vehicle – provisionally to be known as the New Zealand Local

Government Funding Agency (LGFA) – so long as it succeeds in obtaining the high credit rating (at or near AAA) that will be necessary to underpin its economics. Together these nine local authorities represented 54% of the rates income of the New Zealand local government sector in 2009.

10. The proposal for a LGFA has also been presented to a much wider group of local authorities, who have received it with interest and given it broad support.

Status quo and problem definition

11. Under the status quo, local authorities borrow individually to fund their infrastructure and other capital development needs. Because councils (especially smaller councils) issue debt in a fragmented way and typically in relatively small quantities, the costs incurred are significantly greater than would otherwise be the case. The normal way to quantify borrowing cost is by interest-rate margins over some benchmark measured in basis points (where 100 basis points equal one percent interest). The currently incurred greater cost is in the range of 50 to 70 basis points depending on the local authority compared to an estimate of what could be achieved,. This is not a case of market failure or scarce capital, but one of a co-ordination failure to reduce the current fragmented issuance of local authority debt.

12. The forecast borrowing needs of local authorities are large – total borrowings could reach $10 billion within five years from a current level of around $6 billion. Reductions in cost of the order of 50 to 70 basis points will potentially make a big difference but will not be realized under the status quo.

13. Large New Zealand issuers of debt stand to gain from the flexibility to borrow in foreign currencies from time to time. Under the Local Government Act 2002 (LGA), local authorities are not permitted this freedom. Because this restriction applies to the new Auckland Council, it presents a further problem with the status quo.

14. The formation of the new Auckland Council has created a local authority that is several times larger than the next largest. For example, the existing debt (2009) of the new Auckland Council is around six times larger than that of Christchurch City Council or Wellington City Council. This size difference will flow through to future borrowing. The Auckland Council will struggle to meet its future borrowing needs from domestic capital markets. This reflects not only the size of these needs but also the concentration of credit risk arising from the amalgamation of the previous councils in the Auckland region. This is because large investors set limits on what they are prepared to lend to any one entity.

15. While the status quo allows councils to borrow offshore almost none do because the size of their borrowings does not make it cost effective. Moreover they can only borrow offshore in New Zealand dollars which reduces flexibility and increases costs. With the formation of Auckland Council there is, for the first time, a local authority that needs, and can justify, accessing offshore capital markets because of the large size of its borrowings. But the Auckland Council would not be able to do this cost effectively under the status quo because it would not have the flexibility to borrow in foreign currencies as well as New Zealand dollars.

Objectives

16. The Government's objectives are to:

- support local authorities in their efforts to coordinate effectively to achieve the maximum savings in the cost of their borrowings; and
- facilitate the development of New Zealand's capital market through the creation of a new class of asset that will yield benefits to wholesale and retail investors and financial institutions through its availability, liquidity, regularity of issuance and range of maturities.

17. In setting these objectives the Government is giving effect to the recommendations of the Capital Markets Development Taskforce in a manner that is efficient (i.e. does not impose any unnecessary burdens on councils or other players), equitable (does not prevent any councils, particularly smaller ones who potentially stand to make the greatest relative savings) from participating, and at nil or very minimal risk to ratepayers and taxpayers.

18. The Government has previously committed $5 million towards achieving a solution to the challenge of widening, and reducing the cost of, local authorities' borrowing options. Any options will need to be advanced on the basis that there will unlikely be any additional financial contribution forthcoming from the Crown.

Regulatory impact analysis

19. The options are broadly:

1. The status quo – i.e. individual local authorities continue to seek to borrow from domestic capital markets for infrastructure and other requirements, at relatively high cost.

20. The first section of the RIS examines the status quo and the costs of not changing it. The status-quo option would mean that individual local authorities continue to pay higher costs of capital than they might otherwise if they were able to utilise their collective mass and power to realise economies of scale. It would also mean losing an opportunity to contribute to capital market development by creating a deep and liquid market in a new, low-risk security.

21. It has been estimated that under the status quo local authorities together pay around $25 million annually more in interest than they might under the single local-government debt vehicle option discussed below. This cost adds to local authority rates and/or constrains alternative higher-priority uses that local authorities could put that money towards.

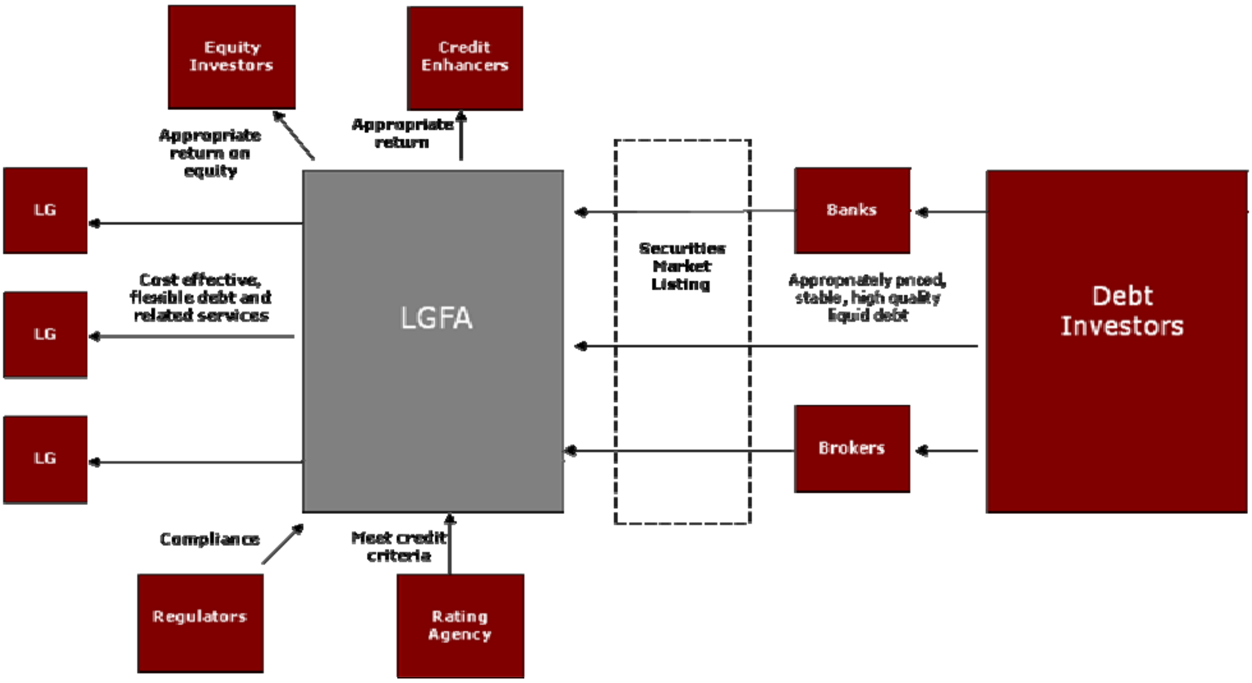
2. Central government borrows and then on-lends to local authorities at a lower cost of capital than the local authorities could individually obtain.

22. This option transfers risk from ratepayers to taxpayers. It also potentially constrains central government's choices about how to prioritise the use of the amount of capital that it judges prudent to borrow under its fiscal strategy. Moreover, this option might also raise the cost of borrowing for central government given the additional risk exposure that would come onto its balance sheet. It might also expose central government to moral hazard if local governments were to act on the assumption that the Crown would make good any loan defaults by them.

3. Central government facilitates the establishment of a single local-government debt vehicle, to enable local authorities to borrow more cost effectively than they currently are able to.

23. Under this option a single vehicle (called the Local Government Funding Agency or LGFA) would issue generic local-authority bonds to wholesale and retail investors and on-lend the funds raised to participating councils to meet their infrastructure and other capital investment needs. Participation by councils would be voluntary but would need to be significant to generate the economies of scale to cover administration, marketing and other largely fixed costs. The following diagram shows the flows of funds from investors (on the right) to individual local governments (on the left). Other key elements are the capital

structure of the LGFA, the regulations it would operate under, and the rating that the rating agencies award it. The Crown's $5 million contribution to improve local authority borrowing options would, under this option, be used to fund a minority equity stake in the LGFA, with the other shareholders comprising a range of the larger local authorities.



24. This option would potentially save local authorities around $25 million per annum through reduced costs of capital. To put this in context, it is a modest but useful annual saving equivalent to just over 13% of the average annual rates increase observed in the past decade. The reductions in finance costs to individual local authorities (ranging between 49 and 67 basis points) are illustrated in the following table (all interest rates are expressed as margins relative to the 5-year swap rate and expressed in basis points or bps):

Potential LGDV 5 Year Pricing Benefits (all bps)									
LG Borrowers	Standalone LG Borrowing Rate	AAA Rated LGDV Borrowing Rate	Net LGDV Margin	Base Case LGDV Operating Costs (Yr 5)	Base Case Potential Borrowing Rate Savings (Yr 5)	Potential Pricing	Pricing Policy	Base Case Potential Borrowing Rate Savings With Pricing Policy	Potential Pricing with Policy
AA+ rated	120	65	55	21	34	86	-15	49	71
AA rated	135	65	70	21	49	86	-10	59	76
AA- rated	140	65	75	21	54	86	-5	59	81
A+ rated (generic LG)	145	65	80	21	59	86	0	59	86
A rated	150	65	85	21	64	86	0	64	86
Un-rated	160	65	95	21	74	86	7	67	93
As at August 2010									

25. Cheaper finance would benefit local authorities by enabling them to spend more on other priorities and less on servicing debt. It would also potentially decrease the pressure for rates increases, thereby benefitting ratepayers in another way.

26. The underpinning economics of the savings in borrowing cost are the economies of scale and scope in debt issuance and marketing, thereby overcoming the costs arising from the current fragmented approach. This option would bring to fruition the latent benefit arising

from local authorities' very strong powers to levy rates in order to pay interest on, and make repayments of, their loans.

27. Another benefit of this option would be the resultant development of a deeper and more liquid market in standardised local authority bonds, which would be a positive development for both wholesale and retail investors and capital markets in New Zealand more generally. It would also complement the development of a "covered bond" market in New Zealand which is being facilitated by the Reserve Bank. Having several high-quality, liquid, but different classes of securities will assist the development of the New Zealand capital market in several ways including: better opportunity to price credit quality at a range of maturities, a range of high-quality securities available for financial institutions to hold; and enhanced liquidity and transparency.

28. A central assumption of this option is a very high credit rating for LGFA debt. Obtaining this requires a very specific design of the vehicle and its relationship to local authorities who use it and to the Crown. These design features are the key reason for the regulatory and legislative changes that are being sought (and are described) in the Cabinet Paper.

29. The design of the LGFA to enhance its credit rating include its capital structure, its ability to 'repo' the bonds of some of the councils that it lends to with the Reserve Bank[1], a set of joint and several guarantees among a subset of the participating councils, and a standby facility with the Treasury Debt Management Office. These features will enable the LGFA to cover any temporary period of illiquidity in the unlikely event of a default by a borrowing council. Moreover, it is important to note that any such default will almost certainly be a case of a temporary lack of liquidity rather than insolvency. This is because of the very strong powers of local authorities to levy rates and enforce these if necessary with charges over property.

30. This option is likely to have some negative impact on certain firms that currently do business with local authorities to help them raise funding, i.e. these firms would lose some business. However, under a cost-benefit analysis this negative impact is offset partly by a transfer (from the firms to ratepayers) and partly by a positive welfare gain through replacing a high-cost structure with a lower-cost one – giving an overall net gain in welfare. In addition, there will be opportunities and other advantages for firms under the proposed new arrangements. There is appreciation of this among many (but not all) players including the major banks.

31. A number of legislative changes will be needed to bring a LGFA into effect. These are outlined below in the section on 'Implementation'

4. Contract out the task of a raising local government debt to a single private-sector provider

32. This option may be feasible but it would be likely to suffer from several disadvantages compared with option 3:

[1] A security is "repo-eligible" if is on a Reserve Bank list of securities that meet certain quality standards ('eligible' securities). A holder of eligible securities can offer them to the Reserve Bank in exchange for their cash value and a right to re-purchase them at a later date as a means of generating temporary liquidity.

- It would be unlikely to attract a sufficient number of local authorities to achieve the necessary economies of scale (local authorities expressed a strong preference for owning the vehicle themselves);
- Even highly rated private-sector financial entities (such as New Zealand banks) have a lower credit rating and cannot raise funds as cheaply as the LGFA is likely to be able to achieve;
- A variety of agency risks (e.g. operational, liquidity and solvency risks) add to the reasons that this option would not achieve the cost savings, or the contribution to capital market development, that option 3 is likely to achieve.

5. Exempt Auckland Council from the current prohibition on local authorities from borrowing in foreign currencies.

33. As a company, and not itself a local authority, the LGFA will have the power to borrow in foreign currencies. This is appropriate given that the LGFA will be a large and sophisticated debt issuer. As outlined in the 'Status quo and problem definition' section above there is also a strong case for Auckland Council to be exempted from section 113 of the Local Government Act 2002 (LGA) that prohibits local authorities borrowing in foreign currency.

34. The prohibition in the LGA dates back to a succession of local government reforms from around 1990. These reforms gave local authorities greater autonomy in return for greater transparency and accountability in the conduct of their affairs. Previously local authorities needed approval from a central agency – the Local Authority Loans Board - to raise loans. The reforms abolished the Loans Board and gave local authorities the autonomy to arrange their own borrowing. However, the reform limited this freedom to borrowing in domestic currency given a perceived risk to New Zealand's reputation because foreign lenders might not appreciate the autonomy of New Zealand local authorities and that they are not backed by a central government guarantee. There are also obvious risks from borrowing in foreign currencies particularly for small and medium sized councils that might lack the capability and sophistication to manage these risks prudently.

35. Auckland Council will have large future borrowing needs on a similar scale and sophistication to the LGFA. Moreover, because of its size, Auckland Council will be unable to meet more than half its future borrowing needs through the LGFA and will need to maintain a large borrowing programme on its own behalf. In this regard it is different from all other local authorities including other large ones such as Wellington City Council and Christchurch City Council.

36. Both the LGFA and Auckland Council will have borrowing programmes of sufficient size to justify offshore placements and the freedom to borrow in foreign currencies. This size will also justify investing in the capability to manage the risks of borrowing in foreign currencies. We expect that the LGFA and Auckland Council will both invest in this capability and so prudently manage the risks of foreign-currency exposure in line with financial best practice.

37. The particular benefits of accessing offshore debt markets and borrowing in foreign currencies include:

- there can be up to a 50bps lower cost through accessing offshore markets;
- offshore markets provide diversification and access to longer maturities - New Zealand's domestic market struggles to provide any meaningful liquidity beyond 5 years;
- the US, Euro and Sterling markets provide significant depth and higher certainty of execution than the domestic, often-retail-orientated market;

- the ability of the Auckland Council and the LGFA to fund offshore in foreign currencies will enhance competition. For example, if the domestic market knows that Auckland Council cannot access offshore demand there will be less tension in the pricing and this will naturally disadvantage Auckland Council.

Consultation

38. The work on options for cheaper funding for local government has been led by Local Government New Zealand with support from a number of the larger local authorities, the Treasury, the Reserve Bank of New Zealand, and the Office of the Minister of Finance. More recently the Department of Internal Affairs (DIA) has become involved and the Inland Revenue Department has been consulted on tax matters. MED and the Securities Commission were consulted on prospectus requirements. The core group of local councils involved in the work (largely represented by their Chief Financial Officers) has comprised Auckland City and Manukau (pre-amalgamation), Hamilton, Tauranga, Wellington and Christchurch City Councils, Wellington Regional Council, and Whangarei, Western Bay of Plenty and Tasman District Councils.

39. The proposal for a LGFA has also been presented to a much wider group of local authorities who received it with interest and gave it broad support.

40. As previously mentioned, the proposed option was discussed and given positive support by the Capital Markets Development Taskforce. It was also discussed and given endorsement through the Jobs Summit process.

41. Cameron Partners (investment bankers) and Asia Pacific Risk Management (financial advisors to a number of councils) have acted as consultants on the project. They in turn consulted with a range of institutions (AMP, ACC), banks (ANZ, BNZ, ASB and Westpac) and overseas jurisdictions that have similar single-vehicle arrangements for local-authority funding (Norway, Sweden and Denmark). They also sought legal advice from Simpson Grierson who are specialists in the law for local authorities.

42. Treasury and DIA officials reported jointly to the Minister of Finance and the Minister of Local Government on 20 September 2010 on the main features of option 3, and on the need for the government to provide legislative and other support (including a role for Treasury's Debt Management Office) in order to implement it. Both Ministers agreed the recommendations of this report including taking a paper to Cabinet (Treasury report T2010/1769 refers).

43. DIA raised some concerns about proposed amendments to the Local Government Act 2002 but these have now been resolved. The concerns centred on avoiding the amendments having wider effect than intended, for example not overly widening the circumstances in which authorities or creditors can impose a rates charge. These concerns have been resolved through discussions between DIA and Simpson Grierson.

44. A question arose about the tax status of the proposed vehicle. In IRD's view it should be treated as a Council Controlled Trading Organisation and therefore taxable. An alternative view was that it should be non-taxable in line with the status of local authorities raising finance themselves on an individual basis. The Minister of Finance and Minister of Revenue considered this issue on 9 November and agreed that the LGFA should be tax exempt (Tax Report T2010/2717 refers).

45. Because options 3 and 5 will require legislation, an enabling Bill would go to a Select Committee of Parliament. This would offer a further opportunity for consultation and testing the merits of the proposal and the specifics of the proposed legislative changes.

Conclusions and recommendations

46. In Treasury's view the preferred way forward is a combination of options 3 and 5, i.e. for central government to facilitate the establishment of a single local-government debt vehicle and allow Auckland Council to borrow in foreign currencies. Option 3 will enable local authorities to combine their resources and purchasing power to achieve the necessary economies of scale to provide for more cost-effective borrowing than is possible at present. It will also contribute to capital-market development. The size of the loan book of the LGFA is expected to reach $2-5 billion within 5 years.

47. Option 5 will give Auckland Council the needed flexibility to manage its large borrowing programme (of which less than half can likely be met through the LGFA) and yield benefits in the form of greater competition and reduced cost. .

Implementation

48. Option 3 will require the promoters of the LGFA to obtain credit ratings from the international rating agencies and for these to be high enough to make the economics work. A process to obtain credit-rating assessments from the agencies is under way with the agencies expected to provide their assessments within the next two months. Thus this crucial uncertainty will be largely resolved before councils make their final decisions about whether to commit to using the LGFA and Parliament considers legislation to enable the LGFA to work. Nevertheless, the credit rating assessments will be predicated on a positive outcome of these two sets of decisions.

49. There is a guiding principle for the various legislative changes proposed in the draft Cabinet Paper to facilitate the setting up and ongoing operation of a LGFA: the vehicle is simply a conduit for a range of local authorities to enable them to achieve collectively what they could do individually but will mostly choose not to - because of the superior efficiency of the collective vehicle. Therefore the vehicle should have the entitlements and exemptions (where they are relevant to its function) that local authorities already possess in law.

50. The changes requiring legislation and the reasons for them are:

- Exclusion of the LGFA from Part 5D of the Reserve Bank of New Zealand Act 1989 because local authorities are excluded;
- Deeming the LGFA to be a local authority for the purposes of the Income Tax Act 2007 (this will exempt it from income tax);
- Exempting the LGFA from the need to issue prospectuses because local authorities are exempted from this requirement under the Securities Act 1978;
- Amending the Local Government Act 2002 to ensure that local authorities can individually, and jointly and severally, guarantee the debts of the LGFA and the debts of individual local authorities to the LGFA, and that these guarantees can be supported by a charge over rates. These provisions are needed to enable the LGFA to obtain the highest possible credit rating;
- Authority for a standby facility for the LGFA on commercial terms and only for exceptional and temporary liquidity shortages; and
- No guarantee of the LGFA by the Crown in order to avoid risks to taxpayers.

51. If these amendments are progressed in Parliament in the early part of calendar 2011 then it is possible that the single local-government debt vehicle could be operational by the second half of calendar 2011. It is anticipated that the legislative amendments will receive cross-party support in Parliament.

52. Options 3 and 5 are expected to entail a relatively simple enabling Bill that will have minor implications for the Local Government Act 2002, the Reserve Bank of New Zealand Act 1989, the Securities Act 1978 and the Income Tax Act 2007.

53. It will be vital that sufficient local authorities commit to become shareholders and users of the LGFA. The CEOs of nine large councils have already signed letters of intent in this regard. Full council approvals await the bedding in of new councils following the recent local government elections. A high proportion of the remaining local authorities are expected to use the LGFA because of the cost savings it will deliver to them.

54. In 2011, work will proceed to set up the LGFA. This will include agreeing a constitution for the LGFA, developing borrowing and lending policies, appointing directors and staff, setting up an office and making outsourcing arrangements. The set up costs are expected to fall in the range of $1-3 million with these being funded out of shareholders' equity (i.e. both the Crown and local authorities who are shareholders will fund these costs). No additional on-going compliance costs for ratepayers, taxpayers or businesses are expected. There will very likely be savings in administrative costs through scale and specialisation.

Monitoring, evaluation and review

55. The Government will work with shareholder councils to develop a monitoring and evaluation plan for the LGFA. In addition, the LGFA proposal includes subjecting the LGFA to regular reporting and accounting requirements, high levels of transparency, and supervision by trustees on behalf of investors.