Proposal to join the Local Government Funding Agency Scheme

INVERCARGILL CITY COUNCIL

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Introduction

The Invercargill City Council is considering participating in the New Zealand Local Government Funding Agency Ltd (LGFA) scheme. The LGFA is designed to allow local authorities to borrow at more favourable interest rates.

The LGFA is a council-controlled trading organisation (CCTO) established by a group of local authorities and the Crown. There are 31 shareholders, comprising the New Zealand Government (20%) and thirty councils (80%). The LGFA governance structure comprises the New Zealand Government and thirty councils, the LGFA Shareholders Council and the LGFA Board of Directors.

The LGFA Shareholders Council comprises five-to-ten appointees from the Council Shareholders and the Crown.

The LGFA Board is responsible for the strategic direction and control of the LGFA's activities, and is led by an independent chair.

All local authorities are able to borrow from the LGFA. Different benefits apply depending on the level of participation. Most local authorities borrowing from LGFA enter into guarantees in favour of LGFA and other local authorities. However, this is not compulsory. A local authority can choose not to provide these guarantees, which means it will not have this contingent liability, but would only be able to borrow a limited amount ($20,000,000), and will be required to pay higher interest rate.

Council is proposing it will participate as a Guaranteeing Local Authority, one which guarantees the obligations of the LGFA.

Principal Shareholding Local Authorities are required to invest capital in the LGFA, and expect to receive a return on that capital; it is acknowledged that this may be less than might be achieved by alternative investments. This is because the overarching 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.

It is not proposed that Council be a Principal Shareholder at this stage.

Summary of the Proposal

Given the short nature of this entire Statement of Proposal, Council is not producing a separate summary, this full version also serves as the summary.

Statutory Considerations

Section 56 of the Local Government Act 2002 (LGA 2002) requires that before a local authority may establish or become a shareholder in a council-controlled organisation, the local authority must undertake consultation in accordance with section 82. Although Council is not proposing to acquire shares in the LGFA, borrowing under the LGFA Scheme will require it to acquire some capital notes issued by the LGFA that could, in some circumstances be converted into shares in the LGFA.

Reason for the proposal

Council believes that participating in the LGFA Scheme provides an opportunity to borrow at lower interest margins, and that this benefit outweighs any costs and risks associated with the LGFA Scheme.

Council is proposing it will participate in the Local Government Funding Agency as a Guaranteeing Local Authority, one which guarantees the obligations of the LGFA.

Council is consulting on this proposal for the reasons set out above under "Statutory Considerations".

Analysis of Reasonably Practicable Options

The reasonably practicable options are as follows:

1. Participate in the LGFA scheme as a Principal Shareholding Local Authority.
2. Participate in the LGFA scheme as a Guaranteeing Local Authority, but not a Principal Shareholding Local Authority.
3. Participate in the LGFA scheme, but not as a Principal Shareholding Local Authority or as a Guaranteeing Local Authority.
4. Not participate in the LGFA scheme.

That analysis is supplemented by some consideration of Council's specific circumstances below.

Q. Should Council participate in the LGFA Scheme as a borrower?

As at 30 June 2018 the level of the Council's borrowing is $88.14 million. This is expected to increase to approximately $132.36 million as shown in the 2018-28 LTP. Consequently, the benefits of lower interest margins are significant.

Based on these forecasts Council anticipates interest savings of approximately $4,000 or 0.4% for every $1.0 million of debt by participating as a Guaranteeing Local Authority. At the peak debt level of $132.36 million this equates to approximately $528,000 per annum. There are one off up-front costs associated with joining the LGFA of approximately $24,000 and annual ongoing costs of approximately $7,000. The Council believes that the benefit of these savings outweigh the costs of borrowing from LGFA.

Joining LGFA as a member council does not mean Council has any legal obligation to use LGFA for its borrowings. Council is free to borrow from whatever borrowing source is the cheapest at the time of borrowing.

Consequently, Council proposes that option (4) is NOT adopted.

Q. Should the Council participate in the LGFA Scheme as a Principal Shareholding Local Authority?

Investing in the LGFA Scheme as a Principal Shareholding Local Authority would provide a return on the amount invested in purchasing shares in the LGFA. It would also give the Council some rights in relation to the governance of the LGFA. However:

a. Any return paid would be a return on equity and would not be paid if the LGFA ever got into financial strife.
b. The Council would have to invest additional capital to join the LGFA scheme, because it would need to purchase shares in the LGFA.
c. The Council would be required to subscribe for uncalled capital in the LGFA; and
d. The Council would have to also become a Guaranteeing Local Authority with the attendant risks detailed below. In any event, the Council would not easily be able to join

as a Principal Shareholding Local Authority. Among other things it would need to find a current Principal Shareholding Local Authority that was prepared to sell some of its shares in the LGFA to the Council.

Consequently, Council proposes that option (1) is NOT adopted.

Q. Should Council participate in the LGFA Scheme as a Guaranteeing Local Authority?

If the Council joined the LGFA Scheme as a Guaranteeing Local Authority, it would be able to borrow more than $20million from the LGFA and would be charged a lower interest margin for its borrowing.

LGFA currently has 59 member councils and is the largest lender to the local government sector with loans outstanding of approximately $8.5 billion. One of the contributing factors to the success of LGFA in delivering low cost funding to the sector has been its AA+ credit rating. This is the same as the New Zealand Government. Currently LGFA estimates it is delivering costs savings to its member councils of $25 million annually. This saving would otherwise need to be funded by higher rates.

LGFA would not achieve the AA+ credit rating without the guarantee structure and therefore there would be no savings in borrowing costs to councils.

LGFA Guarantee

Currently there are 48 councils (based on the LGFA September update) who have signed the joint and several guarantee. It is important to note that guarantors are guaranteeing LGFA and not individual councils.

The guarantee is limited to a council's rates income as a percentage of the rates income of all the guaranteeing councils. If Invercargill City Council became a guaranteeing council, it is estimated that Invercargill City Council's share of the guarantee would be 0.86%. This means that if a $100 million call was made under the guarantee, Invercargill City Council would contribute $860,000. This figure may change over time as the percentage of total rates income changes.

When assessing the potential liability or consequence of a call under the guarantee we need to assess the likelihood of a:

1. council defaulting on its loans;
2. loss on the loans even if a council does default; and
3. call on guarantors

All the above three factors have a very low probability due to the following mitigating factors.

Likelihood of Council Default

Performance of the New Zealand Local Authority Sector: There has never been a default by a New Zealand Council. In addition, there is strong oversight of the sector by the Office of the Auditor General (OAG) and the Department of Internal Affairs (DIA). If the Government has concerns over the performance of a council, there are a number of intervention steps that can be taken including the appointment of a Crown Observer through to the appointment of Commissioners.

Likelihood of a Loss on the Loans in event of Default

LGFA has a range of financial covenants. LGFA member councils that borrow from LGFA need to comply with these financial covenants on an annual basis. The covenants restrict the amount of money a council can borrow. In its 2017 report on LGFA, Standard and Poors state that "LGFA's loan quality is exceptional; all loans in its portfolio are neither past due nor impaired since LGFA's inception in 2011. It has sound underwriting processes, which involve periodic compliance to the covenants that it sets".

Further all lending undertaken by LGFA to councils is done with a security charge over the council's rates. This means that in the event of a default by a council, LGFA can appoint a statutory manager who can impose a special rate that would be able to recover the amount owed to LGFA. This ensures all lending to councils is the first ranking creditor.

Likelihood of a Call on Guarantors

As at June 2018, LGFA had capital of $199.4 million. This was made up of $64.3 million of equity and $135.1 million of borrower notes which could be converted into equity. In addition, there is a further $20 million of uncalled capital. This provides almost $220 million of equity that could be used before a call was made under the guarantee.

Further while the New Zealand Government does not guarantee LGFA it is a 20% shareholder in LGFA. In addition, the Government provides a $1 billion committed credit facility to LGFA. This would provide LGFA access to funding in the event of a severe disruption in capital markets which in turn would provide continuity of funding to the New Zealand local authority sector. The Government is a member of the LGFA Shareholder Council.

Governance of LGFA

The Board of LGFA is currently made up of 5 independent directors and 1 non-independent director. A non-independent director is someone who works in the local authority sector. There is a requirement that the majority of the directors are independent. One of the key objectives of the Director's is to protect the interests of the guaranteeing councils.

Performance of Local Authority Financing Vehicles in other Countries

There are many local authority financing vehicles that have been set up and successfully operated in other countries. These include financing vehicles in Denmark, Sweden, Norway, Finland, Netherlands, France, United Kingdom, Japan and Canada. They all utilise a cross-guarantee structure by member councils similar to the structure of LGFA. There has never been a call under the guarantee in any of these countries. The oldest of the entities is in Denmark which has successfully operated for 120 years.

Standard and Poor's Assessment of risk to Council from the guarantee

Standard and Poor's noted in their credit rating report on Auckland Council on 25th September 2018 that:

> *"As part of the arrangements supporting the Local Government Funding Agency (LGFA), Auckland is party to a joint and several guarantee, which we consider a contingent liability. Given the strength of the institutional framework in New Zealand and the requirement that all debt be secured over rates, we believe that the likelihood of a default scenario that would trigger the joint and several guarantee is low. Therefore, the LGFA liability doesn't affect our view of Auckland's contingent liabilities."*

Using the draft risk likelihood and consequence matrix of Council the likelihood is assessed as unlikely (may occur, but not anticipated); and the consequence is insignificant ($860,000 being 0-5% of Council's operating budget) giving an inherent risk rating of Low. Given the annual savings it is a risk that Council is proposing to accept.

Consequently, the Council is proposing that it will participate in the LGFA Scheme, not as a Principal Shareholding Local Authority but as a Guaranteeing Local Authority. Consequently, Council proposes that option (2) is adopted.

Q. ***Should the Council participate in the LGFA Scheme without being a Guaranteeing Local Authority?***

If the Council was to join the LGFA Scheme without being a Guaranteeing Local Authority, the cost of participating would be less. However, it would face higher funding costs, reducing some of the benefit of participating. It is likely that Council would only be able to borrow up to $20,000,000, but Council is anticipating borrowing more than $20,000,000.

The LGFA charges a higher interest rate to Councils that are not guaranteeing borrowers. This would reduce the potential savings to $60,000 per annum, $3,000 or .3% for every million dollars. The limit on borrowing and the higher interest rate would result in a cost to Council, as compared to option 2 of $300,000 to $468,000 per annum. This is offset by the risk of the guarantee, however as stated above the risk of the guarantee is considered to be low, compared to the savings.

Council proposes that option (3) is NOT adopted.

Council Investment Policy

The Investment Policy does not contain provisions to borrow from the Local Government Funding Agency.

The primary objective for Council's interest in LGFA is to lower Council's cost of borrowing. Although Council is not proposing to immediately acquire shares in the LGFA, borrowing under the LGFA Scheme will require it to acquire some capital notes issued by the LGFA that could, in some circumstances be converted into shares in the LGFA. The Investment Policy needs to be amended to provide for this.

The amendment to the Investment policy is to insert the following, immediately before the section titled “Property Investments”:

“NZ Local Government Funding Agency Limited (LGFA)

Council may invest in shares of the LGFA and may borrow to fund that investment.

Council’s objective in making any such investment will be to:

- obtain a return on the investment; and
- ensure that the LGFA has sufficient capital to become and remain viable, meaning that it continues as a source of debt funding for the Council.

Because of this dual objective, Council may invest in LGFA shares in circumstances in which the return on that investment is potentially lower than the return it could achieve with alternative investments.

If required with the investment, Council may also subscribe for uncalled capital in the LGFA.”

Liability Management Policy

The Liability Management Policy does not contain provisions to borrow from the Local Government Funding Agency.

The primary objective of this proposal is to allow borrowing by the Council at lower interest margins than it currently faces.

The Liability Management Policy will be amended to insert the following, immediately before the section titled “Guarantees”:

“NZ Local Government Funding Agency Limited
Council may borrow from the NZ Local Government Funding Agency Limited (LGFA) and, in connection with that borrowing, may enter into the following related transactions to the extent it considers necessary or desirable:

- contribute a portion of its borrowing back to the LGFA as an equity contribution to the LGFA;
- provide guarantees of the indebtedness of other local authorities to the LGFA and of the indebtedness of the LGFA itself;
- commit to contributing additional equity (or subordinated debt) to the LGFA if required;
- subscribe for shares and uncalled capital in the LGFA; and
- secure its borrowing from the LGFA, and the performance of other obligations to the LGFA or its creditors with a charge over the Council’s rates and rates revenue.”

Opportunity to Make Submissions

Submissions are invited on this Proposal. Submissions must:

1. Be in letter form, clearly showing the submitter’s name, address and contact phone number.
2. Be clearly labelled SUBMISSION – LGFA.
3. Indicate whether the submitter wishes to be heard by Councillors in support of his/her submission. (Note – the substance of the submission should be in writing. Verbal presentations should be restricted to around five minutes.)
4. Be received by 5.00 pm on 23rd November 2018

Submissions can be:

Posted to:	Invercargill City Council Submission – LGFA Private Bag 90104 Invercargill 9840
Delivered to:	Civic Administration Building Invercargill City Council 101 Esk Street Invercargill
E-mailed to:	policy@icc.govt.nz