2016/02

REPLY BY THE MINISTER OF THE TREASURY AND RESOURCES DEPARTMENT TO QUESTIONS ASKED PURSUANT TO RULE 6 OF THE RULES OF PROCEDURE BY DEPUTY LAURIE QUERIPEL

A number of concerns have been raised publicly regarding the creation of a States £330m Bond and its ongoing implications. Treasury and Resources have provided some responses but many aspects remain unclear. The following questions are submitted under Rule 6 of the Rules of Procedure.

Question 1

What is the total sum to date of Bond money that has been taken up by States related entities (trading bodies etc)?

Answer

£122million.

Question 2

What is the balancing sum placed and on what terms?

Answer

As set out in the 2016 Budget Report (paragraph 6.64 – reproduced below):

> *"The Bond issue proceeds which have not yet been lent on to entities form part of either the General Investment Portfolio or the Cash Pool which is invested in line with the direction set by the Treasury and Resources Department's Investment Sub-Committee."*

Question 3

What interest rate is being paid by the participating States related entities?

Answer

The interest rates vary to reflect the term of the borrowing, any change in market conditions compared to when the Bond was issued and the 'credit-risk' of each entity and range from 3.625% to just over 4%.

Question 4

Before T&R committed to the Bond there must have been discussions on ties and attractions in pre-existing financial arrangements and in addition there must have been agreements in principle with target States related entities, can the Department please confirm this and explain why take up has been so slow and sparse?

and

Question 5

What plans have been, or are being developed for use of the balancing sum?

and

Question 6

How has it been envisaged that a large and fixed thirty two year old Bond would be matched to what should be a reducing need by States related entities?

and

Question 7

Which States related entities have resisted being involved?

Answer

As set out in the 2016 Budget Report (paragraph 6.61-6.63 – reproduced below):

> *"There are some entities which currently have external borrowings, guaranteed by the States of Guernsey, where breaking the existing arrangements and replacing with a loan from the Bond issue would not, at this time, be cost effective (e.g. due to cost of exiting fixed rate arrangements [Cabernet Ltd], historical borrowings which are at very favourable rates [Guernsey Housing Association], the attractiveness of short-term funding in the current interest rate environment [Guernsey Electricity Limited and Ladies' College]). There are some entities where the timing of the funding requirement has changed including in respect of the Waste Strategy and Guernsey Electricity Limited where there is no longer an immediate requirement to replace a cable.*
>
> *Notwithstanding that it would inevitably take a period of time to lend on the proceeds of the States of Guernsey bond issue, the amount currently approved is lower than was anticipated at the time of issue. However, the reasons are largely considered to be short-term timing issues and it is reiterated that there are significant financing requirements in the short to medium term which could be funded from the Bond issue proceeds including:*
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> - *Guernsey Water: Belle Greve IV Outfalls replacement project and to bring wastewater infrastructure up to acceptable levels;*
> - *Guernsey Housing Association: to continue development of affordable housing;*
> - *Guernsey Electricity Limited: further infrastructure requirements including, potentially, a direct cable to France.*
>
> *In addition, as set out paragraphs 5.16 to 5.22, the continuing work on reviewing the capital structures of the States trading entities could result in a proposed change to capital structures which would be likely to require funding from the Bond proceeds."*

Question 8

At what stage was it known that up front costs would be in the order of £14.6m?

and

Question 9

Was there any call on the hedge?

and

Question 10

In the actual event who were the beneficiaries of the hedge?

Answer

Paragraph 6.58 of the 2016 Budget Report (reproduced below) details the breakdown of the £14.6m costs associated with the issue of the bond:

> *"The costs of £14.6million associated with the issue of the bond have been amortised, classified as a prepayment on the States of Guernsey balance sheet and will be written off over the thirty two year life of the bond. These costs comprise £9.3million for interest rate locks which were entered into in order to protect the coupon payable against market rises between the time the bond issuance was agreed by the Treasury and Resources Department and the actual date of issue; £3.8million due to the actual yield payable being 3.445% (standard practice is that coupons are rounded down to the nearest 1/8th per-cent and an appropriate adjustment made to the proceeds received) and £1.5million of fees (including legal counsel, financial advisers, credit rating agency and banks / book-runners)."*

The cost of the interest rate locks was not known until the bond was issued. An interest rate lock is a financial instrument entered into which allows for the gilt yield applicable to the bond issuer (which is the major component of the interest rate applicable to a bond issue and fluctuates due to changes in market conditions) to be fixed at a point in time in advance of the actual bond issue. If the gilt yield is lower at the time of issue than the value entered into with the interest rate lock, there is a cost to the bond issuer and a receipt for the issuer of the financial instrument. If the gilt yield is higher at the time of issue that the value entered into with the interest rate lock, there is a cost to the issuer of the financial instrument and a receipt for the bond issuer.

As set out above, the £3.8million is to recognise that the actual yield is 3.445% whereas the bond has a coupon of 3.375%.

The costs of £1.5million were agreed in advance of the bond issue (a significant proportion were a fixed percentage of the value of the bond including bookrunner fees and credit rating).

Question 11

In light of the up front costs, never formally put before States members, what reasoning led to the actual hedge figure of 50%?

Answer

As part of the 2015 Budget Report, the States approved (recommendation 27):

> *"To authorise the Treasury and Resources Department to issue a States of Guernsey Bond of £250million with a minimum term of 20 years and a maximum term of 40 years at such a time and on such terms as that Department considers to be in the best interests of the States………."*

It was considered that hedging 50% of the anticipated value of the bond issue would be appropriate to manage the risk of rising gilt yields given prevailing market conditions and, taking into account gilt yields at that time, should result in a rate that would, inter alia, be lower than the consolidated interest rate paid on existing debt.

Date of Receipt of the Question: 20 January 2016

Date of Reply: 3 February, 2016