States Bond Issue

Commissioned by the Scrutiny Management Committee

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Final Report

May 2017

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Sir Charles Frossard House
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19 May 2017

Dear Sirs

States Bond Issue

In accordance with our signed engagement dated 7 November 2016 and its attachments (the 'Engagement Letter'), we enclose a copy of our final report on the States bond issue.

As stated in our Engagement Letter, you have agreed that this final written report supersedes all previous oral, draft or interim advice, reports and presentations, and that no reliance will be placed by you on any such oral, draft or interim advice, reports or presentations other than at your own risk. The agreed scope of our work is detailed in the Appendices.

Our report is for the benefit and purpose as outlined in our Engagement Letter. We understand that you may wish to make our report publically available by means of appending it to a covering Scrutiny Management Committee report. We will consent to it being appended to a report on the basis that it is reproduced in its entirety. Our report should not be regarded as suitable to be used or relied on by any parties beyond the context and scope for which it was prepared.

The scope of work for this report has been agreed by the addressees and to the fullest extent permitted by law we will not accept responsibility or liability to any other party (including the addressees' legal and other professional advisers) in respect of our work or the report.

Yours faithfully

KPMG Channel Islands Limited

KPMG Channel Islands Limited

Important notice:

Our work commenced on 7 November 2016 and our fieldwork was completed on 4 May 2017. Factual accuracy feedback was received up to 16 May 2017. We have not undertaken to update our report for events or circumstances arising after that date.

In preparing our report, our primary source has been internal management information and representations made to us by P&R. We do not accept responsibility for such information which remains the responsibility of the P&R. Details of our principal information sources are set out within the document and we have satisfied ourselves, so far as possible, that the information presented in our report is consistent with other information which was made available to us in the course of our work in accordance with the terms of our Engagement Letter. We have not, however, sought to establish the reliability of the sources by reference to other evidence. This engagement is not an assurance engagement conducted in accordance with any generally accepted assurance standards and consequently no assurance opinion is expressed.

Due to rounding, some numerical data in this report may not agree by +/-£0.1m compared with other balances presented throughout this report.

The contents of our report have been reviewed by P&R and Guernsey Electricity who have confirmed in writing the factual accuracy of this report.

Glossary

A&O	Allen & Overy
Base rate	Bank of England base rate
Billet d'État	States's Billet d'États
BMSC	Bond Management Sub-Committee
Bond	A debt investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate
Bps	Basis points, equivalent to a 0.01% change in interest rates
Capex	Capital Expenditure
CC	Clifford Chance
CISE	Channel Islands Securities Exchange
CPI	Consumer Price Index
DB	Deutsche Bank
Deloitte	Deloitte Touche Tohmatsu
EY	Ernst and Young LLP
FRS	Financial Reporting Standards
GDP	Gross Domestic Product
GEL	Guernsey Electricity Limited
GHA	Guernsey Housing Association LBG
Gilt	Fixed interest loan security issued by the UK government
GIP	General investment pool
HSBC	HSBC Bank
IBSC	Investment and Bond Sub-Committee
Inter alia	Among other things
IAM	International Asset Monitor Limited
IFRS	International Financial Reporting Standards
ISC	Investment sub-Committee
ITT	Invitation to Tender
LIBOR	London Interbank Offer Rate
LTIR	Long term investment reserve
MO	Mourant Ozannes
MTIR	Medium term investment reserve
P&R	The Policy and Resources Committee of the States of Guernsey
PC	Policy Council
Project Cross	EY's funding options report of April 2014
PQQ	Pre-Qualification Questionnaire
RBC	Royal Bank of Canada
RBSI	Royal Bank of Scotland International
RLAM	Royal London Asset Management Guernsey
RPI	Retail Price Index
S&P	Standard & Poor's

Glossary (continued)

SMC	Scrutiny Management Committee
SoD	The States of Deliberation
States	States of Guernsey
STSB	The States' Trading Supervisory Board
T&R	The Treasury and Resources Department of the States which ceased to exist from April 2016
TMF	TMF Group
Trading Bodies	States owned entities, trading accounts and funds, the Guernsey Housing Association, the Alderney Housing Association and the Ladies College
UK	United Kingdom

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Executive summary

Introduction and background

Issuance detail

On 12 December 2014 the States raised a £330 million public bond with a 32 year tenor listed on the CISE. The Bond was issued with a coupon of 3.375% (re-offer yield of 3.435%) which was described by the States as the lowest ever coupon for a long-term fixed rate Sterling bond issued without a guarantee from the UK government.

Background to the issuance

Historically the States have helped facilitate borrowing for their Trading Bodies through acting as guarantor to external banks or providing internal loans from the States' General Investment Pool. Acting as a guarantor was historically a condition required by the banks and it was considered that it would allow the Trading Bodies to access debt at a lower overall cost to the States. The States have not traditionally charged the Trading Bodies where they acted as guarantor. In September 2013, T&R agreed to guarantee external borrowings up to a maximum of £20m by GEL and that a guarantee charge of 50bps would be levied on the value of the facility draw-down.

T&R advised the States of Deliberation that the blended cost of debt rate for the outstanding loans was estimated at 4.87%. The objective of the issuance was to better this blended rate by consolidating all debt under a single bond where the States would on-lend the proceeds to the Trading Bodies.

T&R's July 2014 States Capital Investment Portfolio Report set out the following principles for funding capital expenditure:

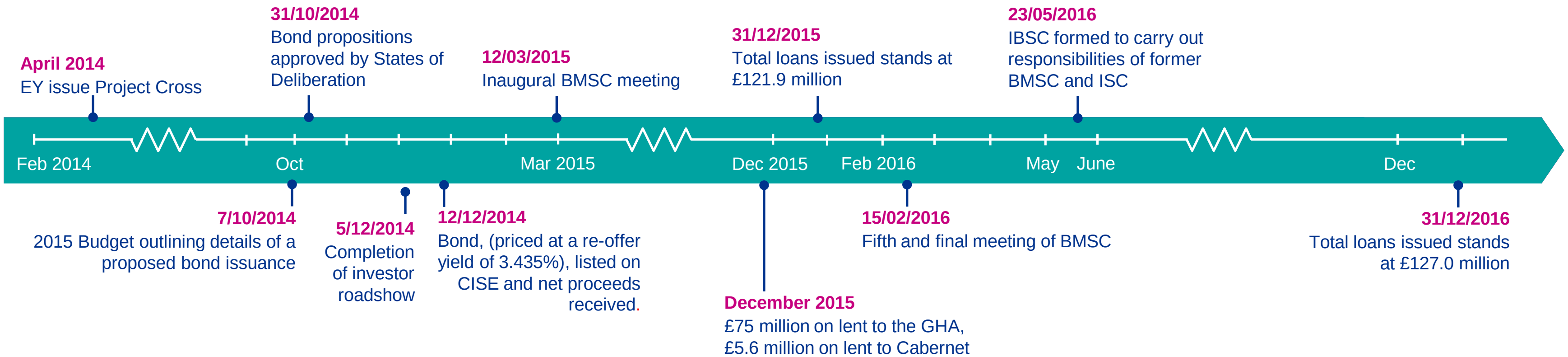
I. Borrowing should only be considered for capital projects which have a defined and discrete revenue stream and only if it can be demonstrated that this revenue stream would be sufficient to repay any borrowing secured against it within the projected lifespan of the asset; and

II. If borrowing for any given project is deemed appropriate, both borrowing from a financial institution and the issue of bonds or other alternative mechanisms (such as the issue of government bonds) be considered.

Detailed proposals were contained in the States 2015 Budget in October 2014 which were subsequently debated and passed by the States of Deliberation later that month.

Timeline

An overview of the timeline of the process is set out below:



Introduction and background (continued)

Key parties and issuance costs

The issuance required a variety of professional advisers, including banks, accountants, lawyers and a rating agency, providing a mix of professional advice, hedging facilities and bookrunner services. The professional adviser fees were determined early in the project but the gilt lock and coupon rounding amounts only crystallised on the Bond issuance on 12 December 2014. The professional adviser fees were a cost of implementing the issue, however coupon rounding and gilt lock costs are effectively part of the financing cost, rather than an implementation cost.

The States initially intended to issue a bond with a tenor of 40 years and Gilt locks were entered into on 18 and 25 November 2014 (£123.5 million and £53 million respectively) covering 53% of the issuance based on this tenor. Following the investor roadshow (1-4 December), feedback from prospective investors led to a reduction in the tenor. A 32 year bond was priced on 5 December and issued on 12 December 2014.

All of the costs, totalling £14.6 million, were cash settled upfront, hence the States received net proceeds of £315.4 million on issuance. The States have capitalised the costs of £14.6 million and are writing them off over the life of the Bond.

Company	Role	Bookrunner fee (£)	Professional advice (£)	Expenses (£)	Coupon rounding (£)	Gilt lock (£)	Capitalised Costs as per Accounts (£)
Issuance costs							
Barclays	Joint lead manager	220,000	-	-			220,000
RBC	Joint lead manager	220,000	-	-			220,000
Deutsche Bank	Joint lead manager	220,000	-	11,912			231,912
Ernst & Young	Financial advisors	-	343,438	6,518			349,956
Deloitte	Reporting accountant	-	37,500	-			37,500
Clifford Chance	To the Issuer as to English law	-	138,550	1,638			140,188
Carey Olsen	To the Issuer as to Guernsey law	-	61,500	-			61,500
Allen & Overy	To the joint lead managers as to English law	-	30,000	109			30,109
Mourant Ozanne	To the joint lead managers as to Guernsey law	-	10,020	301			10,321
TMF Group	Process agent	-	1,950	-			1,950
Standard & Poor's	Rating agent	-	179,800	-			179,800
Issuance costs subtotal		*660,000*	*802,758*	*20,478*			*1,483,235*
Finance costs							
Barclays	Gilt lock			-	-	9,279,044	9,279,044
States of Guernsey	Issuer			2,432	3,824,700	-	3,827,132
Finance costs subtotal		-		*2,432*	*3,824,700*	*9,279,044*	*13,106,176*
Totals		**660,000**	**802,758**	**22,910**	**3,824,700**	**9,279,044**	**14,589,411**

Introduction and background (continued)

Deployment of funds

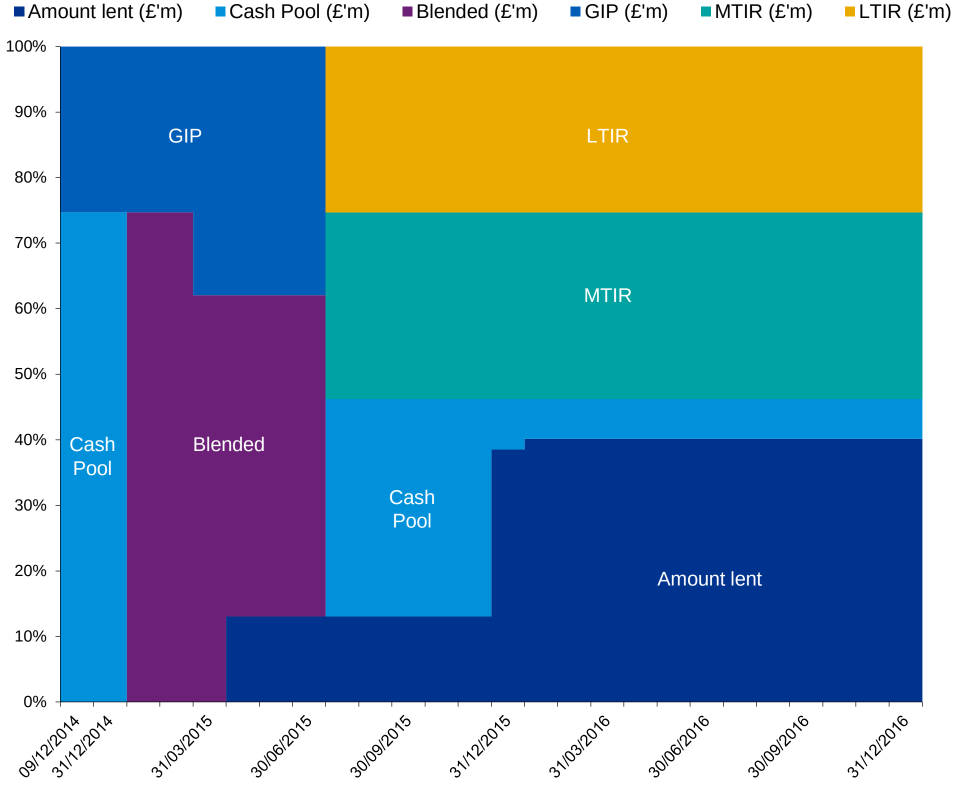
As at 31 December 2016, £127.0m (40%) of the total net proceeds had been lent onto the Trading Bodies at rates ranging from 3.625% to 4.124%. The remaining balance is currently invested as part of the wider States General Investment Pool, predominantly within the Medium and Long Term Investment Reserves

Debt held by Trading Bodies prior to Bond issuance and advanced from Bond proceeds

Recipient	Arrangement Type	Existing Finance (per States Budget 2015) (£m)	Amount Advanced by Dec 2016 (£m)
Guernsey Housing Association	Guarantee	80.5	80.1
Alderney Housing Association	Guarantee	5.0	
Guernsey Electricity Limited	Guarantee	20.0	
Guernsey Electricity Limited	Guarantee	45.0	
JamesCo750 Limited	Internal Loan	13.8	13.1
Cabernet Limited	Guarantee	22.0	23.4
Cabernet Limited	Overdraft	3.0	
Cabernet Limited	Internal Loan	26.0	8.3
Waste Strategy Fund	Pending	29.5	
Ladies' College	Pending	4.0	
HSSD Accommodation Fund	Internal Loan	2.2	2.1
Total		**251.0**	**127.0**

Source: States Budget Report 2015. Data provided by P&R.

Allocation of proceeds from the Bond issue[1]



1 - Note: The above chart is designed to show the allocation of Bond proceeds since the issuance. The chart does not reflect income generated or costs incurred such as investment returns, coupon repayments, loan income received or other administrative costs. Further details of the allocation of these proceeds and key decisions surrounding this matter can be found on page 35 of this report.

Introduction and background (continued)

Current governance structure

The day to day operations of the Bond are managed by P&R, formerly by T&R, through the BMSC which was established with the following terms of reference in March 2015:

- *Agree loan amounts and terms to be made to authorised third parties to fund projects which have already been approved*
- *Advise the investment sub-committee of the quantum and likely requirement dates of any retained bond proceeds to enable investments in the most appropriate manner*
- *Oversee outstanding loans and their repayment*
- *Oversee compliance with the conditions of the Bond*
- *Members are not responsible for managing compliance with the total debt to GDP ratio limit as included within the States Fiscal and Economic Plan*

In May 2016, P&R agreed to establish the IBSC to carry out the responsibilities of the two former T&R Sub-Committees (ISC and BMSC).

KPMG scope of work

We have been engaged to consider the following areas as part of our work:

A – The portrayal of the need for the Bond Issue to the States of Deliberation in October 2014;

B – The 'due diligence' undertaken on the States Trading Bodies lending requirements, prior to the request to the States;

C – The costs associated with the issuance of the Bond, including all parties that were involved in the process and/or receipt of public funds;

D – The Financial Rules of the Fiscal Framework relating to the issue of the Bond;

E – The public information provided by T&R in response to queries raised since the issue;

F – The treasury management of the residual balance following any lending;

G – The financial benefits obtained by using the Bond's proceeds to refinance the loans of the States Trading Bodies; and

H – The current governance, treasury management, usage policy and repayment plan associated with the Bond.

We would like to thank representatives of Guernsey Housing Association, Guernsey Electricity, Guernsey Water, Cabernet (Aurigny), P&R Committee and Treasury staff, and the STSB, for their invaluable support during this important project.

Executive summary - Key findings

Within the scope of our review we have identified the following points of note and, where applicable, we have recommended areas for improvement. Further detail on these points is provided through the supporting analysis section of the report:

Section	Key finding
A **The portrayal of the need for the Bond Issue to the States of Deliberation in October 2014**	A key rationale was to refinance £251 million of existing debt commitments (either outstanding or approved and not yet drawn down) held throughout the States (including the States Trading Bodies). — The need to issue a Bond was portrayed to the States of Deliberation in October 2014 as part of the 2015 Budget. — There was some urgency given to the proposals in order to take advantage of perceived historically low interest rates available in the debt markets, leveraging the States' credit rating. This argument was also relevant for increasing the size of the Bond by £80 million (to a total of £330 million) to reduce the implicit cost of capital on future financing requirements for the short to medium term across the States Trading Bodies. — The States of Deliberation was informed by the T&R Minister during the 2015 budget debate that the "blended rate that are currently being paid in respect of the commercial loans, including the costs of breaking any terms, is 4.87%. So that is the current exposure." We have been provided with correspondence from EY to T&R, dated 28 October 2014, which includes a spreadsheet containing the calculation of the 4.87%, but with the suggestion that 'Break costs / fees associated with refinancing existing debt / cancelling swap agreements" were not included. — It appears there is an inconsistency between what has been calculated by EY and what has been quoted to the States of Deliberation in respect of break costs on existing debt and we have been informed that this was an isolated mistake made by the Minister for T&R when verbally responding to a question raised during debate. We have also been advised that the Q&A document sent to States Members on the eve of the debate (28 October 2014) presented the correct position. — We note from Question 2 of the Q&A: '…However, the overall estimated blended rate of the debt that can be repaid is in the order of 4.87%. It would not be unreasonable to expect the bond issue to generate an all-in rate of around 3.50%-3.75% at current gilt yields. After allowing for costs, this interest rate differential would save in excess of £2.5 million in year one and over £100 million over 40 years…'. We have been informed by P&R that no supporting audit trail, or calculations, exists for these assertions within the Q&A. We were not able to establish who was responsible for drafting the Q&A. — Treasury has suggested that the year one savings of £2.5 million may have been calculated by reference to the minimum interest rate differential of 4.87%-3.75%=1.12% applied against the minimum bond amount of £250 million (amounting to £2.8 million pa), less the costs of the issuance spread evenly over 40 years (amounting to £0.16 million). Question 3 indicates that break costs are estimated at £5.3 million and Question 5 indicates upfront costs of up to £1.15 million, these total £6.45 million or £0.16 million per annum spread evenly over 40 years. — According to the EY Project Cross report estimated break costs of £5.3 million appear to comprise £1.9 million on a Cabernet swap agreement with RBSI, and loan and swap repayment costs for GHA of £3.36 million made up of 11 different line items. — By 31 December 2016 £127.1 million of existing debt arrangements had been refinanced using Bond proceeds. £47 million of this comprised a restructuring of existing internal loan arrangements: HSSD accommodation fund for £2.1 million, JamesCo750 for £13.2 million, and Aurigny for £31.7 million. The residual £80.1 million replaced the existing external debt in relation to the GHA.

Key findings (continued)

B **The 'due diligence' undertaken on the States Trading Bodies lending requirements, prior to the request to the States**	The due diligence undertaken by the States on the Trading Bodies' lending requirements appears relatively limited in practice. EY placed reliance on summary information provided to them by T&R and have specifically caveated as such. — Our discussions with the Trading Bodies suggest that they had very limited correspondence with the States prior to the Bond being issued (with the possible exception of Aurigny who had regular dialogue with T&R for their ongoing day to day funding requirements). — We have not seen any detailed due diligence performed in respect of the £251 million of loans outstanding or approved. — We have not seen any consideration given prior to the Bond issue as to whether all outstanding externally sourced loans throughout the Trading Bodies could be broken in a cost effective manner and/or whether the States have the power to impose centralized funding on them. We understand that autonomy exists within certain Trading Bodies for them to continue to source funding externally and in some cases without looking for a States guarantee. The use of a blended rate is only attractive to Trading Bodies who are unable to achieve a more favourable rate in a commercial market – GEL for example have confirmed that it has, and continues to achieve, a more favourable rate for its planned investments using commercial borrowings. — The 4.87% blended rate calculation appears to be based on the blended interest rates of outstanding external loans and swaps as at October 2014. No account appears to have been taken of the maturity of the swaps. — It is possible that some of the States Trading Bodies could have achieved borrowing terms more favourable than those achieved on the Bond, however this is uncertain and no exercise was completed prior to the issue to compare the current effective blended rate with the rates the Trading Bodies could have achieved in the commercial market. *We recommend in future where decisions are taken centrally within the States, that all affected parties are consulted (in this case the States Trading Bodies) and that their views are documented and formally considered as part of any preparatory work performed.* *We recommend the States clarify the level of autonomy all Trading Bodies possess to access borrowing from third parties in the future.*
C **The costs associated with the issuance of the Bond, including all parties that were involved in the process and/or receipt of public funds**	Three types of costs were associated with the Bond Issue: £1.5 million in relation to professional advisers, £3.8 million in relation to the coupon rounding and £9.3 million on the gilt lock. — The professional advisers fees do not appear unreasonable for a debt issue of this quantum, in the public debt capital markets, given the States' credit rating. — The coupon rounding costs arise due to market convention, whereby a bond's coupon will be rounded down to the nearest 1/8th of a percentage point, from the initial re-offer yield at issuance. The proceeds received by the issuer are reduced to 'compensate' investors for the lower interest payments and to ensure the present value of cashflows in relation to the Bond are the same as if the full nominal quantum had been received and the yield was used to calculate interest payments, rather than the coupon rate. Consequently the States are amortising the £3.8 million over the life of the Bond. — The use of a gilt lock can be an effective tool for managing interest rate risk exposure to a transaction; gilt yields can be volatile and varied by over 0.37% between 03 November 2014 and 11 December 2014. Two gilt locks totalling 53% of the value of the Bond were taken out which is not out of line with expectations if hedging the risk associated with the underlying gilt rate movements is deemed to be appropriate. They were issued at a time when the underlying structure of the deal was not fully known or identified, this therefore presented a risk in the event that the Bond may never be issued and that the terms of the lock may not align to the underlying instrument. The Gilt locks were based on a 40 year Gilt benchmark. The States initially intended to issue a bond with a tenor of 40 years. Following the investor roadshow (1 – 4 December), feedback from prospective investors led to a reduction in the tenor, and hence a maturity mismatch between the Bond and the gilt lock. — We have been provided with extracts from T&R minutes and supporting memoranda from November 2014 which documents the rationale and decisions around entering into the gilt locks.

Key findings (continued)

D **The Financial Rules of the Fiscal Framework relating to the issue of the Bond**	The Fiscal Framework sets guidelines for the maximum level of government borrowing. — We understand that the Fiscal Framework was not tightly defined such that it was unclear whether the 15% of GDP borrowing limit should include external borrowings by the wider States Trading Bodies. Given that the business case put forward for the Bond was to refinance existing States borrowings (including those held by the States Trading Bodies), it would appear inconsistent to not include all States borrowings when comparing against the Fiscal Framework hurdle of 15% of GDP. — As can be shown from the graph on page 30, total States borrowings (including Trading Bodies as well as the Bond) were in excess of the 15% GDP hurdle in 2015 and 2016. — Actual GDP has increased in 2014 and 2015 to £2.345 billion and £2.355 billion respectively which increases the 15% maximum to £352 million and £353 million. Were Guernsey's GDP to fall in the future there is the risk that the Bond alone breaches the 15% threshold and the States may need to undertake remedial action such as buying back a proportion of the debt in the open market. — The ability of the States Trading Bodies to independently borrow from external sources in the future may be restricted by the Fiscal Framework limits, but further analysis would need to be performed by the States in this regard. — As concluded in the 2015 Annual Independent Fiscal Policy Review, the States breached the rules of the Fiscal Framework by borrowing in excess of 3% of GDP in one year. *We recommend that the States revisit the Fiscal Framework and ratify whether borrowings by the States Trading Bodies should be excluded from the 15% of GDP hurdle test. We do not consider that the 2016 revision to the Fiscal Policy Framework clarifies this point.*
E **The public information provided by T&R in response to queries raised since the issue**	11 questions were submitted in connection with the Bond pursuant to Rule 6 of the Rules of Procedure on 20 January 2016 and received responses from the T&R on 3 February 2016. These questions and answers appear to be the only relevant points in the public domain. — Whilst the responses are factually accurate (with the exception noted below) further details would likely have assisted a reader to gain a more comprehensive understanding. In particular questions which dealt with interactions between T&R and the States Trading Bodies. — T&R provided a description of where the funds were invested with reference to the 2016 Budget Report, which indicates that the residual balance was invested in the GIP and the Cash Pool. According to data received from States, as at 31 December 2015 the residual balance was invested within the cash pool, the medium term investment reserve and the long term investment reserve. This appear to be at odds with T&R's response. T&R also provided no details of the terms on which these funds are held. The target returns of the medium term investment reserve and the long term investment reserves are UK RPI + 3% and UK RPI + 4% respectively. *We recommend that the States regularly engages with the public throughout the term of the bond to facilitate public understanding of the intended use for the Bond proceeds.*
F **The treasury management of the residual balance following any lending**	The treasury management of the Bond is conducted by P&R in consultation with IAM an independent firm that provides investment advisory services to the States of Guernsey. — The States have invested the residual Bond money by commingling with their longer terms funds which appears consistent with Proposition 30 approved by the States on 31 October 2014. Whilst there is investment risk associated with this there is a need to balance this risk with the returns required on the Bond proceeds in order to ensure there is no net loss to the States on repayment of the £330 million after 32 years, — We have not seen a detailed plan for deploying the Bond proceeds including projected deployment dates, which may have helped inform the optimum investment strategy whilst funds awaited being lent out. We noted c£103 million was transferred into the Cash Pool in July 2015, but ongoing negotiations with the GHA in particular meant the on-lending did not occur until December 2015. *We recommend that the States prepare a detailed plan for deployment of assets as soon as practicable, taking into account the likely timings of loan requests from the Trading Bodies. This will help inform a balanced investment strategy within the context of their risk parameters.*

Key findings (continued)

G **The financial benefits obtained by using the Bond's proceeds to refinance the loans of the States Trading Bodies**	The principal method used by the States for monitoring the cost or benefits related to the Bond is the Bond Reserve presented in the States accounts. This includes the costs and benefits to the States of the Bond and does not consider the full cost and benefits on the Trading Bodies. — The costs of issuance (see section C) were £14.6 million which are being accounted for by the States by amortising them over the 32 year life of the Bond. Of these only £1.5 million relate to professional advisory fees whereas £9.3 million relate to the Gilt lock and £3.8 million relate to the coupon rounding – the Gilt lock and coupon rounding amounts are cash flows associated with the Bond and the only directly attributable issuance costs are £1.5 million. — By 31 December 2016 £127.1 million of existing debt arrangements had been refinanced using Bond proceeds. £47 million of this comprised a restructuring of existing internal loan arrangements: HSSD accommodation fund for £2.1 million, JamesCo750 for £13.2 million, and Aurigny for £31.7 million. It is difficult to assess whether any financial benefits have been gained from these given these are restructurings within States finances. The residual £80.1 million replaced the existing external debt in relation to the GHA and we understand that costs of £4.2 million were incurred by GHA in breaking existing arrangements1 – however other advantages were gained by GHA in entering into a long term fixed rate arrangement. — Annual coupon payments of £11.1 million will be made for the life of Bond (c3.375% of £330,000,000). Investment returns of £5.1 million were received in 2015. 2016 investment return figures are yet to be finalised, however we have included an estimate below of £17.9 million based on information provided by P&R. — We would question whether any direct financial benefits have accrued to the States and States Trading Bodies in totality from refinancing the loans made to date although investment returns on residual balances appear to have brought the overall position back into surplus in 2016. — It is a very early stage in the evolution of the Bond with only 2 years of the 32 year life having passed. The issue of the Bond allows the States to lend to the States Trading Bodies at a known fixed rate for long term period, providing long term interest rate protection in the event rates rise. Significant benefits may well accrue over the life of the Bond to the States as well as the Trading Bodies. *We recommend that a cost / benefit analysis should be monitored on an ongoing basis to enable the States to better understand the overall success of the issuance and the cost or benefit that will accrue over the life of the Bond for both the States and the States Trading Bodies. This can be based on the Bond Reserve calculation but should include costs incurred to break existing financing arrangements, and the gain or loss realised on the relative financing rates (States vs private finance).*

1 - source: GHA calculations

Key findings (continued)

H **The current governance, treasury management, usage policy and repayment plan associated with the Bond**	On receipt of the proceeds of the Bond T&R were responsible for managing lending to States Trading Bodies and, through the ISC, the treasury management of the residual balance. The BMSC assumed the responsibility for managing lending on its formation in March 2015. Following the election in May 2016 the ISC and the BMSC were merged and assumed the responsibilities of both lending and treasury management of the Bond, reporting to P&R. Current governance and treasury management: — The formation of a BMSC (as indicated under proposition 28 approved by the States 31 October 2014) prior to the issuance, and cognisant of BMSC's terms of reference, may have led to a more rigorous due diligence process, enabling a better understanding of the Trading Bodies' capital requirements and their current cost of capital. — Whilst IAM provide ongoing reporting to the States we are not aware of any periodic reviews performed by, or on behalf of, the States as to the performance of IAM against its mandate. We note a key control for the safekeeping of a significant amount of States assets relates to the reconciliation of investment holdings managed by each of the investment managers to custodian reports. We understand this control is delegated to IAM although this responsibility is not clearly documented in the IAM Advisory Agreement of 31 May 2010. *We recommend that the States conduct periodic reviews of IAM in accordance with best practice and clarifies responsibilities for the regular reconciliation of investment holdings advised by the various investment managers to custodian records.* Usage policy: — We have been provided with a formula used to determine the rate of interest payable by States Trading Bodies on loans received from the Bond proceeds. — Whilst there is a floor on the minimum rate payable by the States Trading Bodies of 3.625% we are not aware of a cap to the adjustment for prevailing rates. This may limit the attractiveness of the Bond to the Trading Bodies should interest rates rise. *We recommend that the States reconsider the attractiveness of the terms of lending to States Trading Bodies as part of any formalised deployment plan (as noted in Section F).* Repayment plan: — The key control used by P&R is an Excel spreadsheet which models actual and forecast cash flows from 2014 to the Bond's maturity in 2046. Sufficient funds are projected to be available at the Bond's maturity to repay the £330 million. The model assumes forecast investment returns on the residual balance of 3.68%. — P&R performs an annual reconciliation of the repayment plan based on the Excel spreadsheet and the Bond Reserve shown in the annual States accounts and hence any discrepancies may not be identified in a timely manner. *We recommend that this is performed more regularly and that the target Investment Return of the residual balance be re-assessed on a regular basis which can help inform the investment strategy.* — We note from Deloitte's management letter following the 2015 audit that a recommendation was made to restrict access rights, formally perform quarterly reviews, as well as to log and approve any changes to, this spreadsheet. *We recommend the status of this be clarified by P&R.*

Supporting analysis

A - The portrayal of the need for the Bond Issue to the States of Deliberation in October 2014

Summary of events

The detailed Bond proposals were contained in the States 2015 Budget Report in October 2014 which were subsequently approved by the States of Deliberation on 31 October 2014.

States Capital Investment Portfolio Report (June 2014)

A reference to the Bond was included in the T&R's States Capital Investment Portfolio Report dated 3 June 2014 and tabled in a States Meeting on 29 July 2014 (Billet d'État XVI). It sets out the following principles for funding capital expenditure in paragraph 129:

I. *"Borrowing should only be considered for capital projects which have a defined and discrete revenue stream and only if it can be demonstrated that this revenue stream would be sufficient to repay any borrowing secured against it within the projected lifespan of the asset; and*

II. *If borrowing for any given project is deemed appropriate, both borrowing from a financial institution and the issue of bonds or other alternative mechanisms (such as the issue of government bonds) be considered."*

The concept of consolidating existing debt was set out in paragraphs 188 through 191:

"There is a widely held belief that Guernsey currently has no debt. However, although no direct borrowing has been undertaken by the States in the recent past, there are significant liabilities listed in the States Accounts through the borrowing arrangements of related bodies such as Aurigny and the GHA being guaranteed, thus creating a contingent liability."

"Presently, all of the agreements in relation to the various companies and their borrowings have been negotiated separately, by each entity, with rates improved somewhat by the existence of a States' guarantee. The T&R does not believe that this is the most cost effective method of providing finance to the entities in question and is currently exploring whether consolidating all of this debt, which all has an income stream to support its repayment, would be more cost effective holistically for Guernsey, provide for more transparency, and ensure that best value was being derived from the States' credit standing."

The next steps in connection with investigating the consolidation of debt was set out in paragraph 192: "*The T&R intends to consult further with the Housing Department, the Public Services Department and the entities for which it acts as shareholder over the coming months, over the practicality and cost effectiveness of such an approach. The Department will also continue to explore the options for providing such financing, including the legal arrangements and protection required before reporting back with detailed proposals as part of the 2015 Budget Report."*

A - The portrayal of the need for the Bond Issue to the States of Deliberation in October 2014 (continued)

States 2015 Budget Report (October 2014)

The proposals for the Bond were set out in Section 7 of the States 2015 Budget Report dated 8 October 2014 contained in the Billet d'État XXII covering the background, existing debt, proposal, and governance and repayment. The existing debt section (paragraph 7.5) states that *"In the recent past, the States have facilitated a material amount of borrowing for the owned or commercial entities… However, the T&R is of the opinion that taking a more strategic approach to the debt could enable the entities to access even better rates by using the credit standing of the States".* The States has also provided internal loans from the States General Investment Pool which are charged the targeted investment return (UK RPI +3.5%). Paragraph 7.6 states that *"These rates are not commercial; they are subject to high and floating interest rates which makes planning for the borrowers extremely difficult and does not provide best value."*

Paragraph 7.7 of the Budget contains the following table which sets out the loans which are either outstanding or approved which the States either directly provide or facilitate by way of a guarantee:

Recipient	Arrangement Type	Amount £m
Guernsey Housing Association	Guarantee	80.5
Alderney Housing Association	Guarantee	5.0
Guernsey Electricity Limited	Guarantee	20.0
Guernsey Electricity Limited	Guarantee	45.0
JamesCo750 Limited	Internal Loan	13.8
Cabernet Limited	Guarantee	22.0
Cabernet Limited	Overdraft	3.0
Cabernet Limited	Internal Loan	26.0
Waste Strategy Fund	Pending	29.5
Ladies' College	Pending	4.0
HSSD Accommodation Fund	Internal Loan	2.2
Total		**251.0**

Source: States 2015 Budget Report

The Budget Report does not contain any indication of the existing interest rate payable on the loan arrangements, but in paragraph 7.9 sets out in a table the indicative savings that would be achieved through lowering the cost of capital by between 0.5% and 2.0% over 1, 20 and 40 years on £250 million of borrowing with indicative savings ranging between £1.3 million (0.5%/1 year) to £200.0 million (2.0%/40 years).

A - The portrayal of the need for the Bond Issue to the States of Deliberation in October 2014 (continued)

The proposals are set out in paragraphs 7.11 through 7.19 of the Budget Report:

"a Guernsey public bond is issued at a minimum of £250 million in order to enable a more strategic view to be taken to financing, to consolidate the existing debt and provide better overall value for the taxpayer and customers"

"The Department is also very conscious that interest rates are at a record low, but are expected to rise soon. The window of opportunity is closing in which the States can lock into and benefit from exceptional market conditions"

"Additionally, the T&R is aware of other financing requirements in the short to medium term . . . lowering the cost of capital available to these companies (Guernsey Water, Housing Association and Electricity) could result in a significant downstream saving to their customers. By way of illustration, a 1% saving on the cost of capital for funding the £80 million additional value would result in a saving of £800,000 per annum (£16 million over 20 years) to customers"

"The T&R will undertake further work on these opportunities to determine whether there is, in fact, merit in taking advantage of the current market conditions to issue a bond up to the maximum allowed within the Fiscal Framework, calculated at £330 million, based on 2013 estimated GDP. For the avoidance of doubt, the Department would only consider allocating any additional funds raised to projects backed by a secure income stream."

The propositions in connection with the Bond were as follows:

- *"27. To authorise the T&R to issue a States Bond of £250 million 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.*
- *28. If recommendation 27 is approved, to delegate authority to the Policy Council to approve an increase in the value of the States Bond issue by a maximum of a further £80 million, following consideration of a justification from the T&R.*
- *29. If recommendation 27 is approved, to note the intention of the T&R to constitute a Bond Management Sub Committee as set out in paragraph 7.20 of this Report.*
- *30. If recommendation 27 is approved, to approve the establishment of a Bond Reserve, as set out in paragraph 7.21 of this Report, to be invested within the States General Investment Pool."*

Proposition 27 was subsequently amended to clarify that the capital raised would be lent to *"States owned entities, trading accounts, and funds, the Guernsey Housing Association, the Alderney Housing Association and/or the Ladies' College on such terms that the Department may approve, subject to each recipient repaying such borrowing in full from a secure income stream and without direct recourse to General Reserve"*

A - The portrayal of the need for the Bond Issue to the States of Deliberation in October 2014 (continued)

States of Deliberation (October 2014)

The States Budget 2015 containing the Bond proposals were presented to the States of Deliberation on the afternoon of Wednesday 29 October 2014 and the Bond propositions were approved on 31 October 2014. The debate on the Bond was documented in Hansard over 41 pages with comments from 30 Deputies.

Rationale for the Bond was made in the opening comments:

— *"Proposed issue of a States Bond to consolidate existing debt which is either directly provided by or guaranteed by the States. This will be a much more cost effective way of borrowing by entities, including Guernsey Electricity, Aurigny and the Guernsey Housing Association"*

— *"That there is only borrowing where there is a secure associated income stream"*

— *"Standard and Poor have today reconfirmed the credit rating of the States as AA+ with a stable outlook and with the highest possible AAA rating for the transfer and convertibility assessment. ….This means that Guernsey should be able to secure extremely attractive rates. Based on current market conditions in gilt yields, I would anticipate that the States bond would issue now with a coupon in the region of 3.5%. Of course, the market conditions may have moved by the time any issue is finalised, but these are historically low rates. If we are to do this, we should move with alacrity to secure the most favourable terms. It is for this reason that our timetable is tight"*

— *"An additional £80 million could be used to reduce the cost of capital of our trading entities to fund further loans that would otherwise seek States' guarantees, or for other potential opportunities such as a help-to-buy style scheme"*

— *"An historic opportunity to lock in long-term low interest rates and achieve better value for the taxpayer and customers of the borrowing entities . . . I would also like to clarify that the T&R may also enter into a pre-hedging arrangement following the passing of the Resolutions and before the date of the issue of the bond, should market conditions warrant it, in order to secure a competitive interest rate"*

— *"The simplest way to view this proposal is that we are seeking to fully exploit our sovereign AA+ credit rating to secure the lowest possible borrowing on behalf of public sector agencies which we control. We will be acting like a bank; we will borrow on the one hand and then we will lend on with a small mark up on the other. The taxpayers will have obtained a small return in the process and the entities and their customers will be better off. The bond proposal cannot in any way be compared to the borrowing of other jurisdictions. This is just good corporate Treasury management"*

The debate on the Guernsey Bond appears polarised with some deputies in favour of the proposals and other deputies opposed.

Within the T&R Ministers' responses to the various matters raised we noted that *"The blended rate that are currently being paid in respect of the commercial loans, including the costs of breaking any terms, is 4.87%. So that is the current exposure"*

A - The portrayal of the need for the Bond Issue to the States of Deliberation in October 2014 (continued)

KPMG Commentary

The need to issue a Bond was portrayed to the States of Deliberation in October 2014 as part of the 2015 Budget.

A key rationale was to refinance £251 million of existing debt commitments (either outstanding or approved and not yet drawn down) held throughout the States (including the States Trading Bodies). There was some urgency given to the proposals in order to take advantage of perceived historically low interest rates available in the debt markets, leveraging the States' credit rating. This argument was also relevant for increasing the size of the Bond by £80 million (to a total of £330 million) to reduce the implicit cost of capital on future financing requirements for the short to medium term across the States Trading Bodies.

The States of Deliberation was informed by the T&R Minister during the 2015 budget debate that the *"blended rate that are currently being paid in respect of the commercial loans, including the costs of breaking any terms, is 4.87%. So that is the current exposure."* We have been provided with correspondence from EY to T&R, dated 28 October 2014, which includes a spreadsheet containing the calculation of the 4.87% but with the suggestion that 'Break costs / fees associated with refinancing existing debt / cancelling swap agreements" were not included.

It appears there is an inconsistency between what has been calculated by EY and what has been quoted to the States of Deliberation in respect of break costs on existing debt and we have been informed that this was an isolated mistake made by the Minister for T&R when verbally responding to a question raised during debate. We have also been advised that the Q&A document sent to States Members on the eve of the debate (28 October 2014) presented the correct position.

We note from Question 2 of the Q&A:

'…However, the overall estimated blended rate of the debt that can be repaid is in the order of 4.87%. It would not be unreasonable to expect the bond issue to generate an all-in rate of around 3.50%-3.75% at current gilt yields. After allowing for costs, this interest rate differential would save in excess of £2.5m in year one and over £100m over 40 years…'

We have been informed by P&R that no supporting audit trail, or calculations, exists for these assertions within the Q&A. We were not able to establish who was responsible for drafting the Q&A

Treasury has suggested that the year one savings of £2.5 million may have been calculated by reference to the minimum interest rate differential of 4.87%-3.75%=1.12% applied against the minimum bond amount of £250 million (amounting to £2.8 million pa), less the costs of the issuance spread evenly over 40 years (amounting to £0.16 million). Question 3 indicates that break costs are estimated at £5.3 million and Question 5 indicates upfront costs of up to £1.15 million, these total £6.45 million or £0.16 million per annum spread evenly over 40 years.

According to the EY Project Cross report estimated break costs of £5.3 million appear to comprise £1.9 million on a Cabernet swap agreement with RBSI, and loan and swap repayment costs for GHA of £3.36 million made up of 11 different line items.

By 31 December 2016 £127.1 million of existing debt arrangements had been refinanced using Bond proceeds. £47 million of this comprised a restructuring of existing internal loan arrangements: HSSD accommodation fund for £2.1 million, JamesCo750 for £13.2 million, and Aurigny for £31.7 million. The residual £80.1 million replaced the existing external debt in relation to the GHA.

B) The 'due diligence' undertaken on the States Trading Bodies lending requirements, prior to the request to the States

Summary of events

An analysis of the funding / capital requirements across the States for FY14 and FY15 was set out in the executive summary of the EY's Project Cross report.

As agreed with the States of Guernsey, our analysis of the total financing requirement focuses on the short-term (i.e. FY14 and FY15)

► The States of Guernsey's short-term funding requirements are presented below. Please refer Appendix 1 for details.

Funding Requirements

Type of Project*	FY14 (£m)	FY15 (£m)	Total (£m)
Cabernet Project & Loan	43.9	-	43.9
Electricity Project	15.0	30.0	45.0
GHA Project & Loan	50.6	13.0	63.6
Water Project	8.8	25.8	34.6
Ports Project	-	4.4	4.4
Waste Strategy Project	29.5	-	29.5
Ladies College	2.0	2.0	4.0
JamesCo Loan	14.0	-	14.0
AHA Loan	5.0	-	5.0
Total	168.8	75.2	244.0

* Pleas refer Appendix 1 for details

Source: Project Cross report (p6)

Supporting analysis for these FY14 and FY15 requirements is set out in the appendices together with longer term finance needs from FY16 onwards split by project (entity). The analysis performed appears to have been based on Information that was sought from the States Trading Bodies by T&R and forwarded to EY. We are not aware of any direct interactions between EY and the underlying States Trading Bodies.

The EY scope per their signed engagement letter states "*we will review Guernsey's projected debt funding needs, including assessment of current guaranteed loans to potential future debt financing options and consideration for gross and net financing requirements over time*". However, page 4 of the Project Cross report contains the caveat "…*It must be noted that we have not performed any due diligence on the information provided by the States of Guernsey. We have assumed that the forecasts provided are estimates and as such, the quantum and timing may vary. In addition we have also assumed that costs are expressed in nominal terms (i.e. include inflation)."*

B) The 'due diligence' undertaken on the States Trading Bodies lending requirements, prior to the request to the States (continued)

States Bond paper – September 2014

T&R considered a paper prepared by the States Treasurer in September 2014 which attached the Project Cross Report and covered the following areas: summary of EY report and recommendations, credit rating, borrowing quantum, providing retail access, repayment, listing, timetable and governance.

The borrowing quantum section of the paper summarises the debt which is currently being guaranteed by the States, provided by way of States internal loans or is pending. The total amount was £250.6 million (please note there are small differences between the amounts in this table and the amounts shown in the 2015 Budget (see table in Section A). We have not reconciled these as they appear to be the result of timing differences).

The paper states that it would *"therefore appear that the minimum issue should be £250m"* based on the analysis above and *"that there should be a recommendation to this effect in the Budget Report"*

In addition the paper identifies £155 million of additional requirements in the short to medium term for Guernsey Water, Guernsey Housing Association and Guernsey Electricity:

— Guernsey Water: £20 million funding required to bring wastewater infrastructure up to acceptable levels and potential requirement for £20 million for Belle Greve LSO (£40 million in total)

— GHA: £40 million of further loan facilities required in the short term, projections for requirements were requested and outstanding at the time of the paper

— GEL: £75 million investment over the medium term to potentially include the cable to France

B) The 'due diligence' undertaken on the States Trading Bodies lending requirements, prior to the request to the States (continued)

Justification for increasing the value of the Bond by up to £80 million – November 2014

Proposition 28, approved by the States on 31 October 2014, resolved to delegate authority to the Policy Council to approve an increase in the value of the Bond by a maximum of a further £80 million, following consideration of a justification from T&R. A paper was produced which was tabled at the T&R meeting on 11 November 2014 providing the justification for presentation to the Policy Council.

The report highlighted potential future investments that were subject to approval totalling £205 million (see table below), and stated that "…*It is reasonable to assume that all of the above will be financed by borrowing".*

The benefits of using the Bond are stated as threefold; lower rates, simplicity, and appropriate capital structure:

- *"The estimate of the blended interest paid on existing debt by States entities is 4.87% . . . But in order to establish a ball-park saving that could be achieved as a result of the trading entities accessing finance via the bond issue, a difference of 1% is reasonable. On a sum of £75m that would represent an annual saving of £750k; over, say, 20 years that represents £15m;"*
- *"A further benefit of the entities using States finance is simplicity. There will be due process and proper governance to ensure every funding agreement is understood and approved by both parties. But it is likely that the process will be simpler and cheaper, representing reduced transaction costs as compared to each entity negotiating their own deals, each one potentially different, and having to incur arrangement fees and to arrange the States' guarantee; and"*
- *"Finally, the bond issuance creates an opportunity to determine the most appropriate capital structure for each trading entity, including whether a move from predominantly a 'save to spend' focus, with some exceptions, to a more appropriate debt/equity funding structure to enable these businesses to take advantage of lower costs of capital."*

The paper concludes to: *"agree the justification for an additional £75m to be issued at the time of the £250m bond issue, request the Policy Council approve the additional £75m and approve the signing off by the Minister of formal resolutions, immediately upon the conclusion of the discussions and decisions contained in this report."* At the time of this report it was perceived that the bond market would expect a total issuance rounded to the nearest £25m. Following further interaction with the banks it was noted that the rounding down from £80m to £75m was not required. Following discussion, members of the T&R agreed the justification for an additional £80 million to be issued at the time of the £250 million bond issue and to request the Policy Council to approve the additional amount.

	2016 £m	2017 £m	2018 £m	2019 £m	Total £m
Cabernet	10			32	42
Guernsey Housing Association	6	12	13	13	44
Water project	10	9	7	7	33
Guernsey Electricity	15	25	35	11	86
Total	**41**	**46**	**55**	**63**	**205**

Source: Memorandum to T&R November 2014

The justification for increasing the value of the Bond by up to £80 million was discussed in a meeting of the Policy Council on 24 November 2014. Members agreed by a majority vote of eight to three to approve an increase in the value of the States of Guernsey Bond issue by up to a further £80 million.

B) The 'due diligence' undertaken on the States Trading Bodies lending requirements, prior to the request to the States (continued)

KPMG Commentary

The due diligence undertaken by the States on the Trading Bodies' lending requirements appears relatively limited in practice. EY placed reliance on summary information provided to them by T&R and have specifically caveated as such.

Our discussions with the Trading Bodies suggest that they had very limited correspondence with the States prior to the Bond being issued (with the possible exception of Aurigny who had regular dialogue with T&R for their ongoing day to day funding requirements).

We have not seen any detailed due diligence performed in respect of the £251 million of loans outstanding or approved.

We have not seen any consideration given prior to the Bond issue as to whether all outstanding externally sourced loans throughout the Trading Bodies could be broken in a cost effective manner and / or whether the States have the power to impose centralized funding on them. We understand that autonomy exists within certain Trading Bodies for them to continue to source funding externally and in some cases without looking for a States Guarantee. The use of a blended rate is only attractive to Trading Bodies who are unable to achieve a more favourable rate in a commercial market –GEL for example have confirmed that it has, and continues to achieve, a more favourable rate for its planned investments using commercial borrowings.

The 4.87% blended rate calculation appears to be based on the blended interest rates of outstanding external loans and swaps as at October 2014. No account appears to have been taken of the maturity of the swaps.

It is possible that some of the States Trading Bodies could have achieved borrowing terms more favourable than those achieved on the Bond, however this is uncertain and no exercise was completed prior to the issue to compare the current effective blended rate with the rates the Trading Bodies could have achieved in the commercial market.

We recommend in future where decisions are taken centrally within the States, that all affected parties are consulted (in this case the States Trading Bodies) and that their views are documented and formally considered as part of any preparatory work performed.

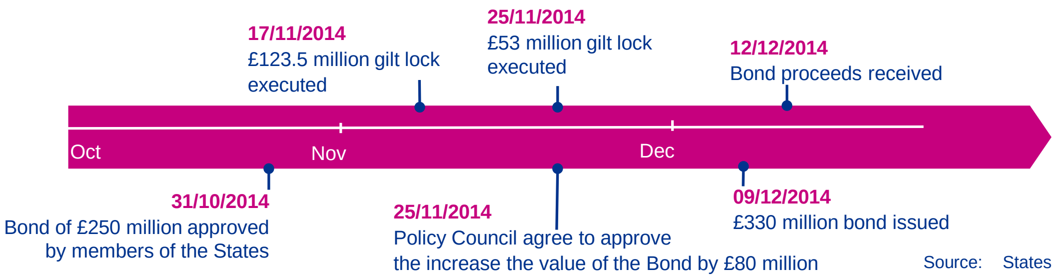
We recommend the States clarify the level of autonomy all Trading Bodies possess to access borrowing from third parties in the future.

C) The costs associated with the issuance of the Bond, including all parties that were involved in the process and/or receipt of public funds

Summary of events

The total costs in connection with the Bond were £14.6 million: £3.8 million on the coupon rounding, £9.3 million on the gilt lock, and £1.5 million on professional adviser fees. All costs were settled out of proceeds from the Bond. Professional adviser fees were determined early in the project and the gilt lock and coupon rounding costs were only known after the pricing on 5 December 2014.

The Gilt yield is the rate the UK government pays to borrow from the private market, and is different from the Bank of England base rate, which is the rate at which banks borrow from the Bank of England. Whilst the base rate has been quite stable for years, the Gilt yield is more volatile. Over the period from 03 November 2014 to 11 December 2014 32 year Gilt yields varied by over 37 basis points, from 2.97% to 2.60%.



Coupon rounding (cost £3.8 million)

The Bond was priced at a spread of 75 basis points above the benchmark December 2046 Gilt which, on the date of pricing, had a yield of 2.685% giving a re-offer yield on the Bond of 3.435% with the coupon payable to investors rounded to the nearest 1/8th of a percent (3.375%). The difference between the re-offer yield (3.435%) and the coupon (3.375%) is reflected in the issue price with the Bond issued at a discount to par value (100 pence). The issue price is calculated as the present value of 32 years of coupons (3.375%) and the repayment of the principal (100 pence) discounted at 3.435% and divided by the principal issue of £330 million. This results in an issuance price of 98.841p which compensates the investors for the lower coupon rate and reduces the upfront proceeds the States receive from investors by £3.8 million. The rounding of the coupon is standard market practice with bond issuances and is outside the issuer's control.

Gilt lock (cost £9.3 million)

Over the period from the date the Bond was approved (31 October 2014) to the pricing date (5 December 2014) the States was exposed to movements in the yield on the benchmark gilt which would impact the coupon payable on the Bond.

The decision to enter into the Gilt lock was taken by T&R to hedge the underlying gilt rate used to calculate the Bond's yield/coupon (although ultimately the gilt locks were out of line with the tenor of the bond issued) prior to the pricing date to reduce the risk of a rise in interest rates that could have a material impact over the life of the Bond bearing in mind the view generally held that interest rates may rise from an historic low. Given the prevailing market conditions, we understand from the T&R Minister that there was a desire to achieve a rate lower than that achieved by the States of Jersey. The Gilt locks were executed in two tranches, £123.5 million in respect of the first £250 million on the Bond, and a further £53 million Gilt lock in respect of the additional £80 million Bond amount. A paper prepared by EY in September 2014 *"A complete guide to pre-hedging future bond issuance: comparison of the different hedging products and a guide to credit and documentation requirements"* and three papers were presented to the T&R in October and November 2014 helped inform T&R's decision.

Due to falls of 0.197% and 0.099% in the Gilt rate between the first and second hedges and pricing respectively the States incurred losses on the Gilt lock but gained on the lower coupon rate payable to investors. Had the Gilt rates moved in the opposite direction the coupon payable on the Bond would have been higher but this would have been compensated for through a gain in the Gilt lock.

Two gilt locks totalling 53% of the value of the Bond were taken out which is not out of line with expectations if hedging the risk associated with the underlying gilt rate movements is deemed to be appropriate. The Gilt locks were based on a 40 year Gilt benchmark. The States initially intended to issue a bond with a tenor of 40 years. Following the investor roadshow (1 – 4 December), feedback from prospective investors led to a reduction in the tenor.

C) The costs associated with the issuance of the Bond, including all parties that were involved in the process and/or receipt of public funds (continued)

Professional advisers

A Pre-Qualification Questionnaire (PQQ) and invitation to tender (ITT) process was performed in selecting the banks to act as lead managers. In total ten banks submitted PQQs of which six were invited to submit tenders, all of whom did. EY produced a report analysing the submissions of the six banks and recommended that three be appointed (Barclays, Deutsche and RBC). This decision was ratified by the T&R in a meeting on 11 November 2014 and the banks were notified on 12 November 2014.

The selection of other external advisers (lawyers, debt adviser, CISE listing sponsor) did not got through a tender process. In the States Treasurer's paper in September 2014 entitled *States Bond* the paragraph on timetable comments "*Given that Jersey has already been through a thorough appointment process through an open tender, it is suggested that the same legal counsel could be appointed without the need to repeat this process. The Director of Corporate Procurement has advised that this approach is acceptable.*"

Breakdown of professional adviser fees

Company	Role	Bookrunner fee (£)	Professional advice (£)	Expenses (£)	Coupon rounding (£)	Gilt lock (£)	Capitalised Costs as per Accounts (£)
Issuance costs							
Barclays	Joint lead manager	220,000	-	-			220,000
RBC	Joint lead manager	220,000	-	-			220,000
Deutsche Bank	Joint lead manager	220,000	-	11,912			231,912
Ernst & Young	Financial advisors	-	343,438	6,518			349,956
Deloitte	Reporting accountant	-	37,500	-			37,500
Clifford Chance	To the Issuer as to English law	-	138,550	1,638			140,188
Carey Olsen	To the Issuer as to Guernsey law	-	61,500	-			61,500
Allen & Overy	To the joint lead managers as to English law	-	30,000	109			30,109
Mourant Ozanne	To the joint lead managers as to Guernsey law	-	10,020	301			10,321
TMF Group	Process agent	-	1,950	-			1,950
Standard & Poor's	Rating agent	-	179,800	-			179,800
Issuance costs subtotal		*660,000*	*802,758*	*20,478*			*1,483,235*
Finance costs							
Barclays	Gilt lock			-	-	9,279,044	9,279,044
States of Guernsey	Issuer			2,432	3,824,700	-	3,827,132
Finance costs subtotal		-		*2,432*	*3,824,700*	*9,279,044*	*13,106,176*
Totals		**660,000**	**802,758**	**22,910**	**3,824,700**	**9,279,044**	**14,589,411**

Source: States, KPMG Analysis

C) The costs associated with the issuance of the Bond, including all parties that were involved in the process and/or receipt of public funds (continued)

KPMG Commentary

Three types of costs were associated with the Bond Issue: £1.5 million in relation to professional advisers, £3.8 million in relation to the coupon rounding and £9.3 million on the gilt lock.

The professional advisers fees do not appear unreasonable for a debt issue of this quantum, in the public debt capital markets, given the States' credit rating.

The coupon rounding costs arise due to market convention, whereby a bond's coupon will be rounded down to the nearest 1/8th of a percentage point, from the initial re-offer yield at issuance. The proceeds received by the issuer are reduced to 'compensate' investors for the lower interest payments and to ensure the present value of cashflows in relation to the Bond are the same as if the full nominal quantum had been received and the yield was used to calculate interest payments, rather than the coupon rate. Consequently the States are amortising the £3.8 million over the life of the Bond.

The use of a gilt lock can be an effective tool for managing interest rate risk exposure to a transaction; gilt yields can be volatile and varied by over 0.37% between 03 November 2014 and 11 December 2014. Two gilt locks totalling 53% of the value of the Bond were taken out which is not out of line with expectations if hedging the risk associated with the underlying gilt rate movements is deemed to be appropriate. They were issued at a time when the underlying structure of the deal was not fully known or identified, this therefore presented a risk in the event that the Bond may never be issued and that the terms of the lock may not align to the underlying instrument. The Gilt locks were based on a 40 year Gilt benchmark. The States initially intended to issue a bond with a tenor of 40 years. Following the investor roadshow (1 – 4 December), feedback from prospective investors led to a reduction in the tenor, and hence a maturity mismatch between the Bond and the gilt lock.

We have been provided with extracts from T&R minutes and supporting memoranda from November 2014 which documents the rationale and decisions around entering into the gilt locks.

Source: States

D) The Financial Rules of the Fiscal Framework relating to the issue of the Bond

Summary of events

The Fiscal Policy Framework was included in Billet d'État No XI dated 29 April 2009 and places limits to fiscal expenditure of the States. Paragraph 8 states:

— "*that the level of gross borrowing by the States may not exceed 20% of Guernsey gross domestic product*" ,
— "*the maximum additional borrowing sanctioned in any one States term may not exceed one times the level of 'permanent' capital expenditure over that time period (3.0% of gross domestic product)"* and
— "*Gross debt can only be accumulated to fund capital investment*"

Gross domestic product was defined in the appendix to the paper as the total value of goods and services produced in an economy (usually reported on an annual basis).

The proposed 20% limit was subsequently revised downwards to 15% of GDP following an amendment, prior to the resolution being passed by the States.

Compliance with the Fiscal Framework has been considered annually since 2010 in the Annual Independent Fiscal Review

The States 2015 budget paragraph 7.11 *states "In order to comply with the limit imposed by the Fiscal Framework, the maximum the States are currently able to borrow is limited to 15% of Gross Domestic Product, or £330 million,"* and paragraph 7.18 continues *"The T&R will undertake further work on these opportunities to determine whether there is, in fact, merit in taking advantage of the current market conditions to issue a bond up to the maximum allowed within the Fiscal Framework, calculated at £330 million, based on 2013 estimated GDP."*

KPMG Commentary

We understand that the Fiscal Framework was not tightly defined such that it was unclear whether the 15% of GDP borrowing limit should include external borrowings by the wider States Trading Bodies. Given that the business case put forward for the Bond was to refinance existing States borrowings (including those held by the States Trading Bodies), it would appear inconsistent to not include all States borrowings when comparing against the Fiscal Framework hurdle of 15% of GDP.

As can be shown from the following graph, total States borrowings (including States Trading Bodies as well as the Bond) were in excess of the 15% GDP hurdle in 2015 and 2016.

Actual GDP has increased in 2014 and 2015 to £2.345 billion and £2.355 billion respectively which increases the 15% maximum to £352 million and £353 million. Were Guernsey's GDP to fall in the future there is the risk that the Bond alone breaches the 15% threshold and the States may need to undertake remedial action such as buying back a proportion of the debt in the open market.

The ability of the States Trading Bodies to independently borrow from external sources in the future may be restricted by the Fiscal Framework limits, but further analysis would need to be performed by the States in this regard.

As concluded in the 2015 Annual Independent Fiscal Policy Review, the States breached the rules of the Fiscal Framework by borrowing in excess of 3% of GDP in one year.

We recommend that the States revisit the Fiscal Framework and ratify whether borrowings by the States Trading Bodies should be excluded from the 15% of GDP hurdle test. We do not consider that the 2016 revision to the Fiscal Policy Framework clarifies this point.

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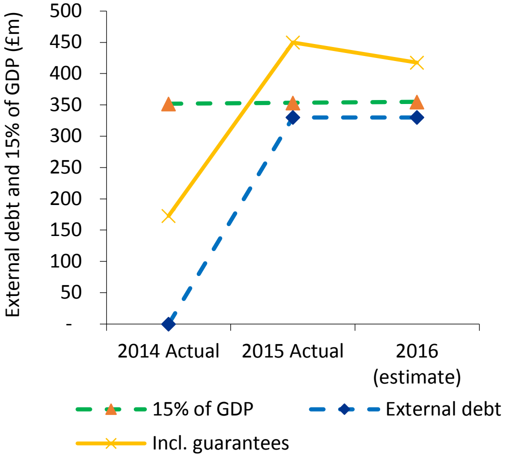
Comparison of external debt to the 15% GDP threshold



E) The public information provided by T&R in response to queries raised since the issue

Summary of events

11 questions were submitted in connection with the Bond pursuant to Rule 6 of the Rules of Procedure on 20 January 2016 and received responses from the T&R on 3 February 2016. These questions and answers appear to be the only relevant points in the public domain.

These questions, along with the response from T&R and KPMG's commentary are presented on the following pages.

KPMG Commentary

Whilst the responses are factually accurate (with the exception noted below) further details would likely have assisted a reader to gain a more comprehensive understanding. In particular questions which dealt with interactions between T&R and the States Trading Bodies.

T&R provided a description of where the funds were invested with reference to the 2016 Budget Report, which indicates that the residual balance was invested in the GIP and the Cash Pool. According to data received from States, as at 31 December 2015 the residual balance was invested within the cash pool, the medium term investment reserve and the long term investment reserve. This appears to be at odds with T&R's response. T&R also provided no details of the terms on which these funds are held. The target returns of the medium term investment reserve and the long term investment reserves are UK RPI + 3% and UK RPI + 4% respectively.

We recommend that the States regularly engages with the public throughout the term of the bond to facilitate public understanding of the intended use for the Bond proceeds.

E) The public information provided by T&R in response to queries raised since the issue (continued)

	Question	T&R response	KPMG Commentary
1	What is the total sum to date of Bond money that has been taken up by States related entities (trading bodies etc.)?	*£122m*	T&R provided an accurate headline figure for the amount of funds committed from the proceeds of the Bond. The question does not ask for a detailed breakdown of individual amounts but the amounts outstanding as at 31/12/2015 were: — Guernsey Housing Association: £75.0 million — Cabernet Ltd: £31.7 million — JamesCo: £13.1 million — HSSD Accommodation Fund: £2.1 million.
2	What is the balancing sum placed and on what terms?	*As set out in the 2016 Budget Report (paragraph 6.64), released in October 2015: "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 T&R's Investment Sub-Committee.*	According to data received from States, as at 31 December 2015 a total of £183.23 million was invested as below: — £17.14 million in the cash pool — £88.59 million in the medium term investment reserve — £77.50 million in the long term investment reserve T&R also provided no details of the terms on which these funds are held. The target returns of the medium term investment reserve and the long term investment reserves are UK RPI + 3% and UK RPI + 4% respectively.
3	What interest rate is being paid by the participating States related entities?	*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%.*	All rates appear consistent with those indicated by T&R.

Source: T&R response to Deputy Queripel questions under Rule 6 of the Rules of Procedure (3 February 2016)

E) The public information provided by T&R in response to queries raised since the issue (continued)

	Question	T&R response	KPMG Commentary
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 (1) and explain why take up has been so slow and sparse (2)?	*As set out in the 2016 Budget Report (paragraph 6.61-6.63): "There are some entities which currently have external borrowings, guaranteed by the States, 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 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:* *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 Bodies could result in a proposed change to capital structures which would be likely to require funding from the Bond proceeds.*	1) The answer makes no reference to discussions or agreements in principle with target States Trading Bodies prior to the issue of the Bond. Please see Section B for further details 2) The answer highlights four factors: high break costs on existing debt, historic borrowing on favourable rates, attractiveness of short term funding in the external market and timing issues on large projects that have been delayed. We would question whether the first three factors might have been identified (prior to the Bond issue if a greater degree of due diligence had been performed.
5	What plans have been, or are being developed for use of the balancing sum?		T&R's response addresses several specific projects which may be funded using Bond proceeds (Belle Greve IV, Affordable Housing etc) as well as "*continuing work on reviewing the capital structures of the States Trading Bodies*". An analysis on the optimum capital structures and a detailed deployment plan could arguably have been performed and agreed with affected parties prior to the Bond issue.
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?		T&R's response does not appear to address this question.
7	Which States related entities have resisted being involved?		T&R's response does not appear to address this question.

Source: T&R response to Deputy Queripel questions under Rule 6 of the Rules of Procedure (3 February 2016)

E) The public information provided by T&R in response to queries raised since the issue (continued)

<table>
<tr><th></th><th>Question</th><th>T&R response</th><th>KPMG Commentary</th></tr>
<tr><td>8</td><td>At what stage was it known that up front costs would be in the order of £14.6m?</td><td rowspan="3">Paragraph 6.58 of the 2016 Budget Report details the breakdown of the £14.6 million costs associated with the issue of the bond:
The costs of £14.6 million associated with the issue of the bond have been amortised, classified as a prepayment on the States balance sheet and will be written off over the thirty two year life of the bond. These costs comprise £9.3 million 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 T&R and the actual date of issue; £3.8 million 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 £1.5 million 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 £3.8 million is to recognise that the actual yield is 3.445% whereas the bond has a coupon of 3.375%.

The costs of £1.5 million 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).</td><td>Please see section C.</td></tr>
<tr><td>9</td><td>Was there any call on the hedge?</td><td>T&R's response does not address this question. The question is somewhat unclear but appears to be asking whether the States had purchased the option to hedge or whether they had entered into a hedge with no option involved. The interest rate locks used did not involve any options.</td></tr>
<tr><td>10</td><td>In the actual event who were the beneficiaries of the hedge?</td><td>T&R's response does not specifically address this question. Barclays were the counterparty to the hedge.</td></tr>
<tr><td>11</td><td>In light of the up front costs, never formally put before States members, what reasoning led to the actual hedge figure of 50%?</td><td>As part of the 2015 Budget Report, the States approved (recommendation 27):
"To authorise the T&R to issue a States Bond of £250 million 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.</td><td>The response has clarified T&R's interpretation but authority for entering into the Gilt locks by T&R was given under proposition 27 approved by the States on 31 October 2014. Please also see Section C.</td></tr>
</table>

Source: T&R response to Deputy Queripel questions under Rule 6 of the Rules of Procedure (3 February 2016)

F) The treasury management of the residual balance following any lending

Summary of events

The treasury management of the Bond is performed by P&R.

The proceeds of the Bond issue were received by the States (£330 million less costs of issue of £14.6 million) in December 2014. Approximately £236 million was transferred to the Cash Pool, managed by RLAM, in anticipation of loans of £215 million which were expected to be made in H2 2015. The residual £80 million, which was not immediately required was invested in the GIP.

Following consideration of the low returns associated with holding the funds in the Cash Pool c£236 million was transferred out into to the Blended pool. £40 million was transferred to the GIP from the Blended pool in March 2015.

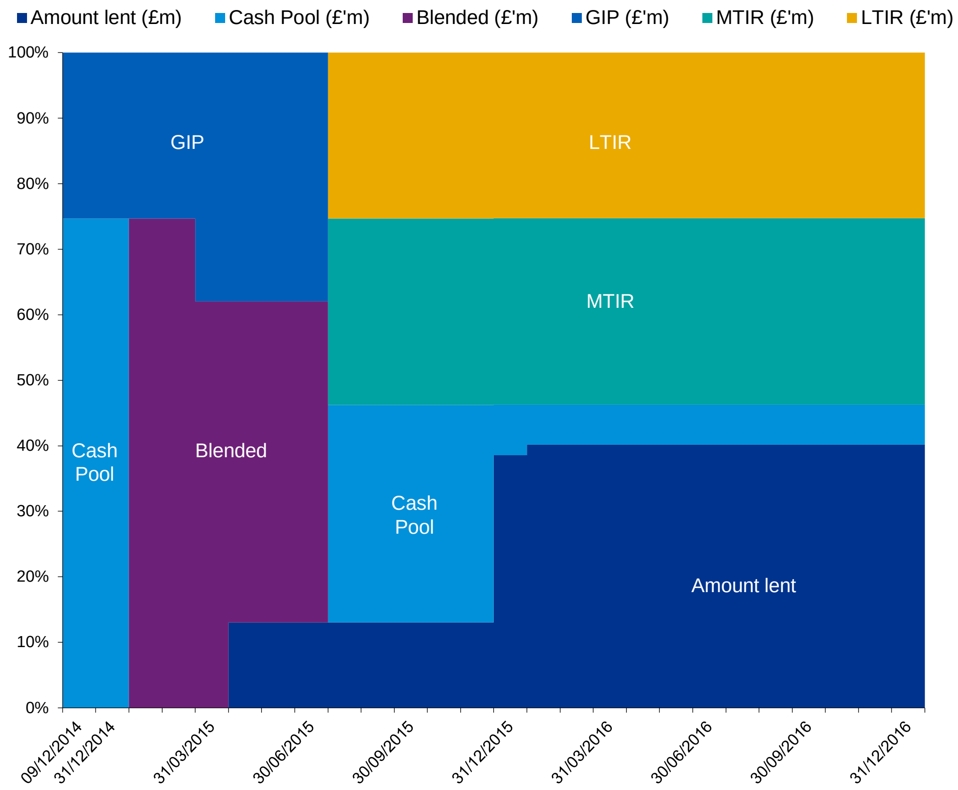
In Q2 2015 loans were made to JamesCo, Cabernet and HSSD totalling £41.3 million.

Following an investment review during 2015, T&R adopted a long-term fund, medium-term fund and short-term cash pool for managing the various funds under its control. In July 2015 £80 million of the bond proceeds were transferred to the LTIR, £90 million to the MTIR and c.£103 million to the Cash Pool in anticipation of further lending to Trading Bodies.

The monies were held in the Cash Pool for longer than anticipated principally due to delays in deploying the funds to the GHA. A total of £75 million, in two tranches, was lent to the GHA and £5.6 million to Cabernet (Aurigny) in December 2015. In Q1 2016 a further £5.1 million was advanced to the GHA from the cash pool.

For the purposes of our work we have relied on information provided to us by P&R and have not sought to reconcile the monetary flows to any independent source.

Allocation of proceeds from the Bond issue



Note 1: The above chart is designed to show the allocation of Bond proceeds since the issuance. The chart does not reflect income generated or costs incurred such as investment returns, coupon repayments, loan income received or other administrative costs.

F) The treasury management of the residual balance following any lending (continued)

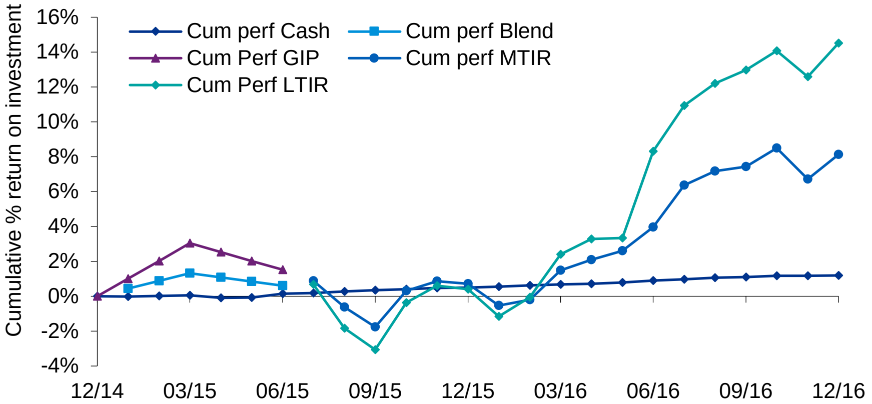
KPMG commentary

The States have invested the residual Bond money by commingling with their longer terms funds which appears consistent with Proposition 30 approved by the States on 31 October 2014. Whilst there is investment risk associated with this there is a need to balance this risk with the returns required on the Bond proceeds in order to ensure there is no net loss to the States on repayment of the £330 million after 32 years, and appears consistent with Proposition 30 approved by the States on 31 October 2014.

We have not seen a detailed plan for deploying the Bond proceeds including projected deployment dates, which may have helped inform the optimum investment strategy whilst funds awaited being lent out. We noted c£103 million was transferred into the Cash Pool in July 2015, but ongoing negotiations with the GHA in particular meant the on-lending did not occur until December 2015.

We recommend that the States prepare a detailed plan for deployment of assets as soon as practicable, taking into account the likely timings of loan requests from the Trading Bodies. This will help inform a balanced investment strategy within the context of their risk parameters.

Cumulative performance of investment reserves



1: 2016 investment returns on the LTIR and MTIR have not yet been finalised. The balance held in each of the LTIR and MTIR show above reflects 31/12/2015 values

Summary and description of investment reserves

Cash pool	
Description	Marketable securities with a maturity >180 days
Target Return	LIBID GBP 3 month+25bps

Long term investment reserve	
Description	A longer term multi-asset investment pool
Target Return	RPI +4.0%

Medium term investment reserve	
Description	A longer term multi-asset investment pool
Target Return	RPI +3.5%

GIP	
Description	A longer term multi-asset investment pool
Target Return	The GIP target return was RPI +3.5%

Cash pool	
Description	Marketable securities with a maturity >180 days
Target Return	LIBID GBP 3 month+25bps

Blended pool	
Description	The blended pool is in effect the assets of the GIP and the Cash Pool

Source: extract from IAM meeting paper 16/12/14 / & Meeting minutes 30/01/15, States Provided Data

G) The financial benefits obtained by using the Bond's proceeds to refinance the loans of the States Trading Bodies

KPMG commentary

The principal method used by the States for monitoring the cost or benefits related to the Bond is the Bond Reserve presented in the States accounts. This includes the costs and benefits to the States of the Bond and does not consider the full cost and benefits on the Trading Bodies.

We are not aware of any further detailed cost/benefit analysis performed at inception or on an ongoing basis.

The costs of issuance (see section C) were £14.6 million which are being accounted for by the States by amortising them over the 32 year life of the Bond. Of these only £1.5 million relate to professional advisory fees whereas £9.3 million relate to the Gilt lock and £3.8 million relate to the coupon rounding – the Gilt lock and coupon rounding amounts are cash flows associated with the Bond and the only directly attributable issuance costs are £1.5 million.

Bond reserve 2014 – 2016 (estimate)

Cost Description	2016 estimate	2015	2014
Balance as at 1 January	**(5,709,000)**	**(573,000)**	**-**
Investment Return	17,948,855	5,074,000	30,000
Interest Received from Loans	4,702,626	1,421,000	0
Coupon Payable	(11,141,000)	(11,141,000)	(579,000)
Issue Costs Written Off	(456,000)	(456,000)	(24,000)
Other Expenses	(34,000)	(34,000)	0
Balance as at 31 December	**5,311,481**	**(5,709,000)**	**(573,000)**

Source 2015 States Accounts, T&R data, KPMG analysis

By 31 December 2016 £127.1 million of existing debt arrangements had been refinanced using Bond proceeds. £47 million of this comprised a restructuring of existing internal loan arrangements: HSSD accommodation fund for £2.1 million, JamesCo750 for £13.2 million, and Aurigny for £31.7 million. It is difficult to assess whether any financial benefits have been gained from these given these are restructurings within States finances. The residual £80.1 million replaced the existing external debt in relation to the GHA and we understand that costs of £4.2 million were incurred by GHA in breaking existing arrangements – however other advantages were gained by GHA in entering into a long term fixed rate arrangement. Annual coupon payments of £11.1 million will be made for the life of Bond (c3.375% of £330,000,000).

Investment returns of £5.1 million were received in 2015. 2016 investment return figures are yet to be finalised, however we have included an estimate below of £17.9 million based on information provided by T&R.

We would question whether any direct financial benefits have accrued to the States and States Trading Bodies in totality from refinancing the loans made to date although investment returns on residual balances appear to have brought the overall position back into surplus in 2016.

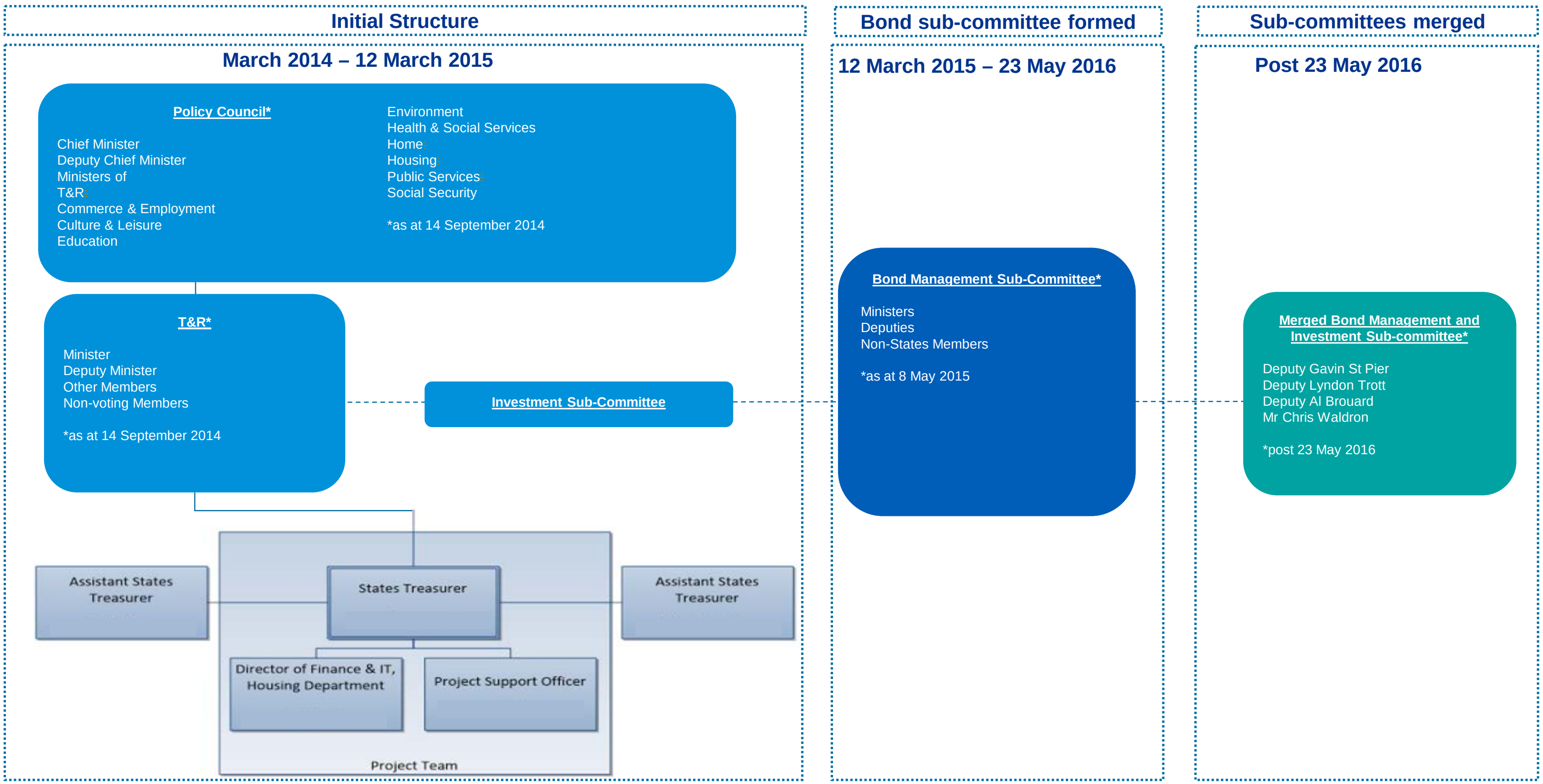
It is a very early stage in the evolution of the Bond with only 2 years of the 32 year life having passed. The issue of the Bond allows the States to lend to the States Trading Bodies at a known fixed rate for long term period, providing long term interest rate protection in the event rates rise. Significant benefits may well accrue over the life of the Bond to the States as well as the Trading Bodies.

We recommend that a cost/benefit analysis should be monitored on an ongoing basis to enable the States to better understand the overall success of the issuance and the cost or benefit that will accrue over the life of the bond for both the States and the States Trading Bodies. This can be based on the Bond reserve calculation but should include costs incurred to break existing financing arrangements, and the gain or loss realised on the relative financing rates (States vs private finance).

H) The current governance, treasury management, usage policy and repayment plan associated with the Bond

Current governance and treasury management

On receipt of the Bond proceeds T&R were responsible for managing lending to States Trading Bodies and, in consultation with the investment sub-committee and IAM, the treasury management of the residual balance. The BMSC formed in March 2015. Prior to this date, its responsibilities were held by the full T&R Board.
Following the election in May 2016 the investment sub-committee and the BMSC were merged.



Source: States, Board minutes

H) The current governance, treasury management, usage policy and repayment plan associated with the Bond (continued)

The terms of reference for the two committees were as follows.

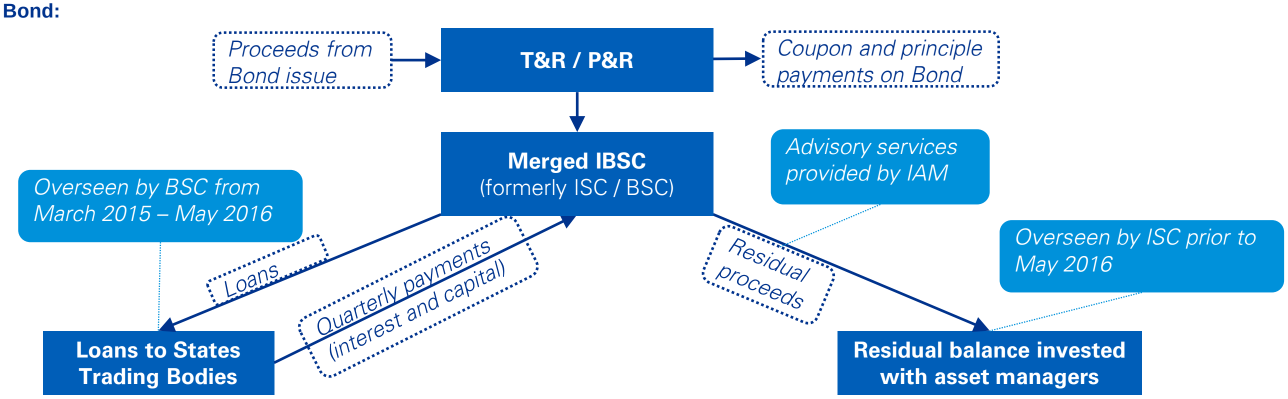
Bond Management Sub-Committee:

-Agree loan amounts and terms to be made to authorised third parties to fund projects which have already been approved
-Advise the investment sub-committee of the quantum and likely requirement dates of any retained bond proceeds to enable investments in the most appropriate manner
-Oversee outstanding loans and their repayment
-Oversee compliance with the conditions of the bond
-Members are not responsible for managing compliance with the total debt to GDP ratio limit as included within the States Fiscal and Economic Plan

Investment Sub-Committee:

-Monitor the performance of investment managers appointed to the States funds
-Manage the process of periodic tendering for investment managers, investment consultants and related services
-Recommend to the Board of T&R any changes required in the mandates of investment managers
-Analyse and prioritise the ongoing diversification of the asset mix of the superannuation fund
-Consider the results of the tri-annual review of the Superannuation Fund and determine whether any investment policy revisions are necessary
-Review the standing investment policies and recommend updates to the Board as necessary
-Develop closer working arrangements with the Social Security Department on their investments and explore ways of more effective use of resources

Governance of the Bond:



Source: States, T&R

H) The current governance, treasury management, usage policy and repayment plan associated with the Bond (continued)

States Investment Review Report (February 2016):

The States Public Accounts Committee engaged BDO Limited on 11 November 2015 to perform an investment review. BDO issued a report on 16 February 2016 and a number of recommendations were made.

We have not been provided with a status update on these recommendations but believe a formal response should be tabled to the Scrutiny Management Committee.

Usage Policy

The lending policy adopted by the States notes that *"borrowing should only be considered for capital projects which have a defined and discrete revenue stream and only if it can be demonstrated that this revenue stream would be sufficient to repay any borrowing secured against it within the projected lifespan of the asset".*

The BMSC has agreed the following formula to be used to determine the rate charged on borrowings:

BMSC terms of lending:	%
Coupon paid by the States	3.375
Add costs of issuance and ongoing administration (Note 1)	0.25
	3.625
Add / (Less) adjustment for prevailing rates (Note 2)	X
Add credit risk score (Note 3)	Y
Applicable interest rate (not less than 3.625%)	Z

Note 1: A premium of 0.25% is applied to account for the costs of the Bond issuance and ongoing administration

Note 2: This relates to the difference between current swap rates for the loan term being requested compared to the swap rate for that loan term applicable on the date the Bond was issued.

Note 3: This is a maximum of 0.3% and is determined by BMSC on the basis of a simple scorecard approach which incorporates key financial rations including profitability, interest cover and gearing and considers the 'proximity to General Revenue' – ie whether General Revenue funded entirely, a General Revenue trading entity, an incorporated States Trading Company or wholly owned arrangement or any other entity.

Rates on loans made to Trading Bodies

Entity	Rate	Term (years)
Aurigny Air Services	4.047%	9
Aurigny Air Services	4.061%	4
Aurigny Air Services	4.066%	5
Aurigny Air Services	4.124%	10
Guernsey Housing Association	3.742%	30
Guernsey Housing Association	3.667%	21
Guernsey Housing Association	3.625%	30
JamesCo750	3.898%	13

Rates received by Trading Bodies have ranged from 4.124% to 3.625%, as left.

Source:States, T&R

H) The current governance, treasury management, usage policy and repayment plan associated with the Bond (continued)

Repayment plan

A spreadsheet is maintained by P&R which models actual and forecasted cash flows from 2014 to the Bond's maturity in 2046. Sufficient funds are projected to be available at the Bond's maturity to repay the £330 million.

The spreadsheet models:

1) The amount loaned to each of the Trading Bodies, and the timing and quantum of interest and capital repayments on these loans

2) The timing and quantum of coupon and capital repayments payable by the States on the Bond, and the issue costs released over the life of the Bond

3) The total amounts lent to States Trading Bodies, the total residual balance, and the investment returns generated by this residual balance

The model assumes forecast investment returns on the residual balance of 3.68%. If investment returns fail to achieve this rate over the life of the Bond there is a risk that the residual balance (including loans repaid) will be insufficient to cover the full £330 million repayable by the States.

We have been advised by Treasury that the spreadsheet is reconciled on an annual basis, but quarterly checks are made to ensure that all loan repayments are received in accordance with individual loan agreements.

H) The current governance, treasury management, usage policy and repayment plan associated with the Bond (continued)

KPMG Commentary

Current governance and treasury management:

The formation of a BMSC (as indicated under proposition 28 approved by the States 31 October 2014) prior to the issuance, and cognisant of BMSC's terms of reference, may have led to a more rigorous due diligence process, enabling a better understanding of the Trading Bodies' capital requirements and their current cost of capital.

Whilst IAM provide ongoing reporting to the States we are not aware of any periodic reviews performed by, or on behalf of, the States as to the performance of IAM against its mandate. We note a key control for the safekeeping of a significant amount of States assets relates to the reconciliation of investment holdings managed by each of the investment managers to custodian reports. We understand this control is delegated to IAM although this responsibility is not clearly documented in the IAM Advisory Agreement of 31 May 2010.

We recommend that the States conduct periodic reviews of IAM in accordance with best practice and clarifies responsibilities for the regular reconciliation of investment holdings advised by the various investment managers to custodian records.

Usage policy:

We have been provided with a formula used to determine the rate of interest payable by States Trading Bodies on loans received from the Bond proceeds.

Whilst there is a floor on the minimum rate payable by the States Trading Bodies of 3.625% we are not aware of a cap to the adjustment for prevailing rates. This may limit the attractiveness of the Bond to the Trading Bodies should interest rates rise.

We recommend that the States reconsider the attractiveness of the terms of lending to States Trading Bodies as part of any formalised deployment plan (as noted in Section F).

Repayment plan:

The key control used by P&R is an Excel spreadsheet which models actual and forecast cash flows from 2014 to the Bond's maturity in 2046. Sufficient funds are projected to be available at the Bond's maturity to repay the £330 million. The model assumes forecast investment returns on the residual balance of 3.68%.

P&R performs an annual reconciliation of the repayment plan based on the Excel spreadsheet and the Bond Reserve shown in the annual States accounts and hence any discrepancies may not be identified in a timely manner.

We recommend that this is performed more regularly and that the target Investment Return of the residual balance be re-assessed on a regular basis which can held inform the investment strategy.

We note from Deloitte's management letter following the 2015 audit that a recommendation was made to restrict access rights, formally perform quarterly reviews, as well as to log and approve any changes to, this spreadsheet.

We recommend the status of this be clarified by P&R.

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