Scrutiny Management Committee

Review of the States of Guernsey Bond Issue Final Conclusions and Recommendations

FEBRUARY 2018

1. Background

During the 2015 Budget Report debate, (the then) Treasury & Resources Department proposed issuing a Bond to the value of £250m under the general premise that the existing borrowing arrangements of the States Trading Bodies and affiliates such as the Guernsey Housing Association, were not the most cost effective and the Bond issuance would *'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 Minister, T&R outlined the details in his speech to the Assembly "*Sir, a key feature of this Budget is the proposed issue of a States of Guernsey Bond to consolidate existing debt which is either directly provided by, or guaranteed by, the States of Guernsey. This will be a much more cost effective way of borrowing by entities, including Guernsey Electricity, Aurigny and the Guernsey Housing Association".*

The States of Deliberation subsequently resolved that a Bond to the value of £250m should be issued. It also resolved that a further £80m could be issued on the delegated authority of (the then) Policy Council, which was duly sanctioned in November 2014. The £330m Bond issue completed in December 2014 with a maturity date of 2046 (a 32 year Bond), and a fixed rate of interest of 3.375%.

2. Scrutiny Panel Review

In late 2016, the Scrutiny Management Committee (the Committee) decided to review several areas of the Bond issue, but in particular, the governance surrounding the issuance of the Bond and the treasury management of the residual balance following any on-lending.

The Committee set up a 'task and finish' panel to oversee the review, of which the members were:
Deputy Chris Green (Panel Chair)
Mrs Gill Morris (Non-States Member of the Scrutiny Management Committee)
Deputy Mark Dorey
Advocate Peter Harwood (Non-States Member)
Mrs Jody Newark (Non-States Member)

The Panel then appointed KPMG Channel Islands Limited (KPMG) to undertake an initial review, which outlined concerns in a number of the areas of the review's Terms of Reference[1]. KPMG's final report was released in May 2017.

The Panel decided that on the basis of the report's findings there were still areas where further clarification was required. In October 2017, a public hearing was held where questions on this subject were posed to Deputy Gavin St Pier, President of the Policy & Resources Committee and Ms Bethan Haines, the States Treasurer, by members of the review panel.

[1] The Terms of Reference are attached as an appendix to this document

3. Conclusions

The Panel has now had the opportunity to assess all the information gathered during this review process and wishes to document its conclusions formally:

Portrayal of the need for the Bond issuance
The original stated aims of the Bond issue within the Budget Report, was to reduce interest costs to the States Trading Bodies, in addition to reducing the overall risk to the States'.

The Panel therefore recommends that the Policy & Resources Committee formally measure and publish the cost effectiveness of the Bond, on an ongoing basis throughout the 32 year term.

The due diligence undertaken on the States Trading Bodies requirements for funds from the Bond proceeds
Prior to the Budget debate there was limited formal due diligence performed by the Treasury & Resources Department in respect of loans outstanding (or in 'approved' status), nor any firm commitment from the entities intended to receive the funds.

It is possible that some of the States Trading Bodies could have achieved borrowing terms more favourable commercially than those proffered by the Treasury and Resources Department from the proceeds of the Bond. However, as no comparative exercise was completed prior to the Bond issue, this is uncertain.

Deputy St Pier stated during the public hearing: *"with the benefit of hindsight, could more have been done? I think that is, in essence, what the KPMG Report is saying: that in their view, probably more could have been done."*
The Panel believes that had the lack of proper commitment from the entities supposedly refinancing from the Bond proceeds been highlighted at the time of the debate, the outcome of that debate may have been different.

Fiscal Framework
The States of Guernsey Fiscal Framework at the time the Bond was proposed was not tightly defined, as it was unclear whether the 15% of GDP borrowing limit included external borrowings by the wider States Trading Bodies.

Given that the business case put forward by the Treasury and Resources Department was to refinance existing such 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 limit of 15% of GDP. Total States' borrowings (including the States Trading Bodies and the Bond), were in excess of this 15% GDP limit in 2015 and 2016.

The Panel agrees with the KPMG conclusion, that the 2016 revision to the Fiscal Policy Framework did not clarify this area sufficiently.

Treasury Management of the funds
Once the funds had been secured, a sufficiently realistic cash-flow forecast was not in place to ensure that optimal returns would be secured quickly.

The Treasury & Resources Department and its Investment Sub-Committee made preparations to invest the additional £80m in longer term funds, but as they believed the bulk of the £250m would be on lent quickly, this was initially invested in a fund yielding significantly less than the required coupon payments.

When questioned by the Scrutiny President in the Committee's public hearing, Deputy St Pier stated that it was *"all of our expectations that a good portion of the proceeds would be lent on faster. So that explains why there was not a race to place them to be managed as part of the investment reserves."*

However, during that same public hearing, the States Treasurer stated that plans **were** in place to invest the funds as soon as they were received.

The Panel believes that had sufficient due diligence and discussion taken place with the States Trading Bodies and Guernsey Housing Association prior to the Bond issue, investment plans would have been better prepared and executed.

Overview of financial benefits

The principal method used by the States for monitoring the cost or benefits related to the Bond, is the Bond Reserve section in the States annual accounts. This section records the costs, interest and other investment returns derived from the Bond proceeds, but does not calculate the full cost and benefits of the States Trading Bodies who have refinanced their existing borrowing from those proceeds.

The Panel is disappointed to note that although Deputy St Pier confirmed at the Committee's public hearing that *"Aurigny's interest costs had reduced by approximately £1m in 2016 as a direct result of taking a loan from the Bond proceeds"*, there is currently no formal mechanism to detail whether any direct financial benefits have accrued to the States' in totality, from refinancing the loans made to date.

4. Recommendations

The Panel notes that a number of the recommendations from the KPMG report (and the previous external auditors of the States of Guernsey) have already been implemented.

These include:

(i) the appointment of a senior member of staff to focus on investments within the Treasury staff;

(ii) improved controls and documentation around management of the funds.

In light of the information received at its public hearing, the Committee have the following additional recommendations:

(i) the Policy & Resources Committee should provide additional clarity to define ‘meaningful compliance’ with the Fiscal Framework. If all borrowings of the States’, the States Trading Supervisory Board and affiliates such as the Guernsey Housing Association, in addition to all contingent liabilities were taken into account, indebtedness would be over the 15% Fiscal Framework limit. The bodies encompassed by the Fiscal Framework need to be clearly defined and all the relevant entities included. The public needs to understand how their indebtedness is recognised and monitored. The liabilities covered should be defined as well as the consequences of breaching the Fiscal Framework. Given that some entities will continue to take external finance, the Policy & Resources Committee needs to clarify whether the States’ will be underwriting/guaranteeing this borrowing.

(ii) the Policy & Resources Committee should clearly define the appropriate circumstances where loans may be granted, specifically where a robust business case is in place to allow repayment of the funds.

(iii) the Policy & Resources Committee should carry out an ongoing cost benefit analysis on the Bond issue, to evaluate the success of the project. This should include the amount lent to date, the residual balance, interest received, interest paid, new loans made since the last statement and potential loans in the pipeline. This should also include an indication of interest that borrowers would have paid externally (assuming guarantees were in place), which would enable taxpayers to evaluate whether the States’ are better off with or without the Bond.

5. Final Comments

It is important to state that the decisions regarding the issue of the Bond have been made. What matters now is that the funds are used for good purposes.

Key considerations moving forward should be:

(i) to reduce the level of risk to the States of Guernsey by exposure to external investment returns;

(ii) adequate monitoring to ensure that the interest income derived from the on-lending of the proceeds of the Bond as originally intended over the life of the Bond is sufficient to cover the interest coupon and the capital repayment of the Bond; **and**

(iii) where possible by on-lending the proceeds to help drive the local economy.

The Committee will continue to monitor the governance arrangements applied to loans made from the Bond proceeds, the management of that loan book and the investment management applied to any unutilised residual balances. The Committee intends to request of the Policy and Resources Committee regular up-dates on such matters.