Tabled information
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184/11P(c)

Submission on Local Government Funding Authority

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The formation of the LGFA implies there is something broken with the existing funding arrangements for Territorial Authorities ("TA"). This is simply not true with Councils being able to debt finance all their needs domestically within the existing market, particularly at time of financial crises where investors migrate towards blue chip investments.

The issue it seems to me is really one of pricing, regulatory risk and loan term.

Pricing seems to be the key issue. There is a sense that TA's ares being asked by the domestic market to pay too much for debt.

The solution proposed is the elevate the credit quality of the debt through the financial engineering inherent in the LGFA structure to "AAA" rating from what is the current Individual TA's typical Investment Grade rating, which is for the larger TA's mostly in the "AA" range. Moving the ratings from "AA" to "AAA" is gilding the lily for the NZ market and explains why the magnitude of the savings achieved which are so trivial , for instance less than $1m pa for WCC. It also creates a situation where the stronger credits support the weaker credits, whereas at the moment each TA borrows on its own credentials

To achieve these minimal savings WCC is required or proposing to:

1. Commit to funding 80% of its needs from the organisation. There is no contestability in this process.
2. Purchase equity in the LGFA and have a contingent liability in respect of uncalled capital.
3. Over borrow by 1.6% for each loan to subscribe for subordinated notes in the LGFA, effectively adding more equity to the structure.
4. Enter a joint and several guarantee arrangement whereby each guarantor assumes a contingent liability for **all** the obligations of the LGFA. This is by far my biggest concern.
5. Move into providing a form of financial services which is completely outside the core activities of any TA.

80 % of the WCC funding will now be packaged as "AAA" rated loans will be even less attractive to retail investors who are desperately keen to buy quality TA paper issued to the public, but offering reasonable returns. We note that WCC has never done a public issue no doubt because of pricing and regulatory issues. This is a great sadness as retail investors are very keen to buy this type of paper provided it shows adequate returns.

The equity return is totally inadequate for what is equity risk on albeit a low risk lender. And it is claimed that the risk is all TA. This is not the case as there will be a policy to keep a liquidity reserve which will probably be invested in bank and Treasury securities. So it is not true that LGFA only lends to TA's. It lends to them but also probably to banks and the Crown as well.

The need to over borrow by 1.6% and invest in subordinated LGFA debt increases WCC risk on the structure as well as increasing its cost of money raised.

The joint and several guarantees are my major objection but are fundamental to the structure. Councillors' will be very familiar with the impact on TA's of the joint and several concept via the leaky homes debacle. What "Joint and several" means is that WCC and ultimately its ratepayers will guarantee up to NZ$11 billion of debt. So WCC is taking on a contingent risk of NZ$11 billion to save itself less than NZ$1 million in interest per annum. I feel that is absurd! I note the Crown does not participate in the guarantee.

It is said that TA loans are very low risk. I agree that they are and I have no knowledge of any default by a TA in New Zealand. However the debt metrics for most councils are deteriorating, from an average of $5113 of debt per ratepayer in 2006 to

$8,304 per ratepayer in 2010 (Larry Mitchell analysis). This trend implies greater and greater reliance on the willingness of ratepayers to assume more and more liability for Council debt against the threat of losing their homes, which is politically difficult. Also the have been defaults in the Local Government sector. The Local Area Hydro defaults by Power Boards of the 1980's require a multi hundred million Government bailout. The credit worthiness of council's relies solely on the willingness of ratepayers to accept continuing rates imposts.

It is correct that the NZ market limits the terms of loans, practically to under ten years.. This can be addressed by borrowing offshore. Access to this market could easily be addressed by an amendment to the Local Government Act , removing the prohibition from borrowing overseas. Additionally no TA to my knowledge has explored the concept on borrowing really long term domestic debt because of perceptions about cost. For instance technically there is nothing to stop TA issuing perpetual debt as a number of banks have done. There is just an assumption that this is not possible for a TA.

The discussion about the lending process are incomplete. It looks to me that provided certain fixed covenant tests are met based on historic accounts (and remember TA 's report only once yearly so accounts can be very stale) all TA/s qualify. This seems very dangerous. With any lending proposition you focus first on the ability of the borrower to service and repay the loans and then after that on the quality of the security if the worst should happen. Here the focus seems to be pretty well solely on the security offered not the capability to service the debt.

Based on the above as a ratepayer I am opposed to WCC participating in the equity investment but more importantly in the guarantee structure of the LGFA. LGFA is a solution looking for a problem, saves little in interest and exposes the Council to huge contingent risks. If anything goes wrong who will pay: the ratepayers!