ABERDEEN CITY COUNCIL

COMMITTEE	Council
DATE	14 December 2016
DIRECTOR	Richard Ellis
TITLE OF REPORT	Bond Financing Strategy – Implications for the Council
REPORT NUMBER	CG/16/152
CHECKLIST COMPLETED	Yes

1. PURPOSE OF REPORT

To update members on the implications of the award of a credit rating by Moody's Investor Services and the bond issuance by the Council.

2. RECOMMENDATION(S)

It is recommended that the Council:

i) Notes that the Bonds are admitted to trading on the London Stock Exchange;

ii) Notes that the Council must act in a manner capable of maintaining its Credit Rating;

iii) Notes that the Council must comply with the Market Abuse Regulations, the Disclosure and Transparency Rules, the Listing Rules and the continuing obligations set out in the London Stock Exchange Admission and Disclosure Standards;

iv) Instructs the Head of Finance to review the Council's financial management systems, processes and routines taking into account the requirements and expectations of holding and maintaining a suitable credit rating and being an Issuer of Bonds and to report back to the Finance, Policy & Resources Committee and Audit, Risk and Scrutiny Committee as required;

v) Instructs the Head of Legal and Democratic Services to ensure that any proposals arising from the Governance Review are aligned to the requirements and expectations of holding and maintaining a suitable credit rating and being an Issuer of Bonds.

vi) Instructs the Head of Legal and Democratic Services to develop and maintain the Insider List(s) on behalf of the Council; and

vii) Instructs the Depute Chief Executive (Director of Corporate Governance) to develop proposals for a Fiscal Policy Panel as described in section 5.9.1 of the report and to report back to the appropriate committee.

3. FINANCIAL IMPLICATIONS

3.1 Whilst there are no financial implications arising directly from the recommendations set out in this report, it is important to note that the issue of the bond places a financial commitment on the Council until 2054. The purpose of the bond was to put in place capital financing for the Council's two capital programmes – namely the Non Housing Capital Programme and Housing Revenue Account Capital Programme, which would normally be done through other forms of long term borrowing.

3.2 Detailed financial implications were covered in a previous report to Council on 17th August 2016, including consideration of: Best Value; Affordability; Investment Strategy; Counterparty List; Prudential Indicators; and Credit Rating.

4. OTHER IMPLICATIONS

4.1 *London Stock Exchange Rules and Regulations*

While the Council's bonds are trading on the London Stock Exchange (LSE), the Council is required to comply with the Market Abuse Regulations, the Disclosure and Transparency Rules, the Listing Rules and ongoing obligations as set out in the LSE Admission and Disclosure Standards. These are more particular set out and summarised in the Briefing Note prepared by the Council's legal advisors as set out in Appendix 1.

4.2 A high level summary of key points are detailed below although this summary is not intended to substitute reading the Briefing Note in full:

4.2.1 *Public Disclosure of Inside Information*

Inside information comprises information of a precise nature that has not been made public, relating directly or indirectly to one or more issuers or to one or more financial instruments, and which if it were made public would be likely to have a significant effect on the prices of those financial instruments or on the price of related derivative financial instruments and information that a reasonable investor would be likely to use as part of the basis for investment decisions.

Information is of a precise nature if it indicates a set of circumstances which exists or which may reasonably be expected to come into existence or an event which has occurred or which may reasonably be expected to occur where the information is specific enough to enable a conclusion to be drawn as to the possible effect of that set of circumstances or event on the prices of the financial instruments or the related derivative financial instrument.

Market Abuse Regulations require the Council, as an issuer, to inform the public as soon as possible of inside information that directly concerns the issuer. This is essential to avoid insider dealing and ensures investors are not misled.

In practical terms Council Officers will be required to consider all matters to determine whether this would constitute inside information. Once the Council is in a position to release this information then there will be an announcement through a Regulation Information Service as detailed in 4.2.4 below.

4.2.2 *Insider Lists*

Market Abuse Regulations requires issuers to:-

- Draw up a list of all persons who have access to inside information;
- Promptly update the insider list;
- Provide the insider list to the appropriate authority (i.e. The Financial Conduct Authority) as soon as possible upon its request.

Insider lists must be retained for at least 5 years.

Insider lists must be kept in electronic form and the format must ensure:-

- Confidentiality of the information included by ensuring that access to the insider list is restricted to clearly identified persons;
- Accuracy of the information contained in the list; and
- Access to and retrieval of previous versions of the list.

In practical terms there will be two types of insider list one which is permanent and another which is project specific. The permanent insider list will be those Officers and Members of the Council who will have access to any inside information. The project specific lists may also include contractors and/or partners of the Council.

As part of the Market Abuse Regulations an “Insider List” must be compiled with this being led by Head of Legal and Democratic Services and work continues to be undertaken on this with a view to having a first draft list completed prior to the end of December. It is highly likely that all elected members will be on this list;

Any person on the insider list will be required to keep the information confidential until it is disclosed by the Council and is deemed public information even if they have ceased to be part of the project (this will include contractors or other external organisations that the Council may work with one a particular project) or the Council.

4.2.3 *Sanctions*

The Financial Conduct Authority (FCA) can suspend trading of a financial instrument, including bonds, where it considers it necessary, under Market Abuse Regulations.

If the FCA is satisfied that a person has contravened Market Abuse Regulations, it can (but is not limited to):-

- Impose a financial penalty on the person for insider dealing and unlawful disclosure of inside information/market manipulation. Instead of a penalty, it can publish a statement censuring the person - maximum of 15million Euros or 15% of the gross annual turnover/gross annual spend. By way of background, the forecasted gross expenditure for Aberdeen City Council in 2016/2017 exceeds £800million.

To suspend, for such period as deemed appropriate, any permission which the person has to carry on a regulated activity and/or to impose limitations/restrictions on a regulated activity by the person. FCA regulated activities are fully detailed in Part 2 of the Financial Services and Markets Act 2000 and include but are not limited to: accepting deposits; dealing in or managing investments (as a principal or agent), arranging investment deals, safeguarding and administering investments, operating a multilateral trading facility; and setting up stakeholder pensions schemes; units in a collective investment scheme; shares; Debt Instruments; and Government Securities.

4.2.4 *Disclosure and Transparency Rules*

An issuer that discloses regulated information, such as inside information, must, at the same time, file that information with the Financial Conduct Authority. An issuer must entrust a Regulation Information Service (RIS) (such as Regulated News Service (RNS)) with the disclosure of regulated information.

5. BACKGROUND

5.1 During this process the Council has been required to prepare and develop new financial information and documentation. In order to continue with obligations arising from the Bond this information and documentation requires to be maintained and updated on an ongoing basis.

5.2 *Securing and Retaining a Credit Rating*

Before the Council was able to issue its bond on the London Stock Exchange, it had to secure a credit rating from a recognised credit rating agency. Having secured the rating, the Council was then able to issue the bond. In determining a credit rating, the agency considered the strength of the institutional framework within which a Scottish local authority operates as well as considering the performance of the economy within which the local authority operates. A summary of Moody's rating methodology can be found at Appendix 2.

5.3 Financial Information

The Council was required to submit detailed financial information to the ratings agency in order to demonstrate its stewardship. This included:

- 3 years Annual Accounts
- Analysis of income and expenditure by category for the previous financial year
- Budgetary performance information for the previous 5 years
- Breakdown analysis of main income streams:- Council Tax, Non Domestic rates, General Revenue Grant, Other Fees and Charges
- Funding projections for the next five years, including projected savings
- Analysis of planned Capital programmes and major projects over the next five years
- Overview of the Housing Revenue account
- Analysis of reserves and balances, past five years and projections
- Treasury Management Policy & Strategy, including the Debt Maturity profile, liquidity policy and prudential borrowing limits
- Credit Metrics – 10 year projections for the following:- Gross operating balance against operating revenue, interest payments against operating revenue, Direct & indirect debt against operating revenue and short term direct debt against total direct debt
- Income Statement – detailed for the past three years and forecasts for the next 35 years (but focussing on the next 3 financial years)
- Cashflow Statement– detailed for the past three years and forecasts for the next 35 years (but focussing on the next 3 financial years)
- Balance Sheet – detailed for the past three years and forecasts for the next 35 years (but focussing on the next 3 financial years)

5.4 *Institutional Framework and Local Governance*

The Council was also required to submit detailed information outlining the institutional framework in which Scottish local authorities operate. This was particularly important, with this being the first time a Scottish Council had been publically rated. The information supplied on the institutional framework included:-

- The Local Government in Scotland Act 2003
- Total Revenue Support
- Local Authority Self-Financed Expenditure
- Statutory & Budgetary Controls of Local Authorities
- The Prudential Code
- Local Authority access to the PWLB

Information was also provided to the agency describing the Council's local governance framework, the political make-up, the committee structure, the executive structure, the decision making process and its key functions and responsibilities.

5.5 *Economic Information & Performance*

The Council was also required to submit a variety of economic information about the city and the city region outlining both its economic performance and potential.

The economic information supplied included:-

- Analysis of GVA income (gross value added) per head
- Productivity, prosperity and employment levels
- Statistics on the diversified economy, with a range of high-value sectors
- Details of City region's past contributions to the UK exchequer
- Information on the City Region Deal
- Details of the City Centre Masterplan
- Current and future demographic profiles
- Information on the local housing market

5.6 *Management Presentation*

Having supplied the credit rating agency with the above information, the final step was for key Council officials to make a management presentation to Moody's at their London offices. This was undertaken in late July.

5.7 *Credit Rating Outcome*

In early October Aberdeen City Council received a credit rating score from Moody's Investor Services ("Moody's") of Aa2, and was placed on negative outlook. The 'negative outlook' mirrors the negative outlook on the UK sovereign rating, following the vote to leave the European Union.

This rating is one notch below UK government, and a high-grade investment rating. It is the third highest rating out of the 21 that Moody's award.

5.8 *Retaining a Credit Rating*

A credit rating will be required to be maintained during the term of the bond. In order to maintain a credit rating, Moody's will be required to conduct reviews at least once every twelve months. Officers will be required to provide any information requested during such reviews promptly.

The Governance Review is developing proposals to ensure that the Council's governance arrangements are aligned with the CIPFA principles of good governance as required under The Local Authority Accounts (Scotland) Regulations 2014 which specify that annual accounts must include an Annual Governance Statement. Aberdeen City Council is the first local authority in Scotland, to obtain a credit rating and issue bonds. The Governance Review Programme Board will therefore work closely with the key regulators, including the London Stock Exchange, to ensure that the outcomes of the Governance Review are aligned not only to the principles of good governance, but to the requirements and expectations of holding and maintaining a suitable credit rating and being an Issuer of Bonds to protect the Council, elected members and officers. For example, maintaining a credit rating places an increased emphasis on the need for caution by officers and members in discussing and/or disclosing information on major projects not in the public domain. Disclosure of information not in the public domain could cause an adverse impact not only on the individual project but also on the overall position of the Council in relation to its credit rating and the issued bonds. There may also be severe personal consequences for any individual officer or elected member as set out in section 4.2.3 of this report. Processes in respect of the handling of confidential information will need to be robust.

5.9 MAIN ISSUES

5.9.1 SUPPORTING THE ANNUAL CREDIT RATING RE-ASSESSMENT - ECONOMY

In support of the annual credit rating reassessment, officers are considering the development of an independent panel of experts that could comment on the performance of the Aberdeen economy, the outlook for the economy in relation to global economies and financial markets and the sustainability of the Council's finances.

A number of models are being considered including the Jersey Fiscal Policy Panel. The State of Jersey is the parliament and government of the British Crown dependency of Jersey. An Assembly passes legislation, approves the annual budget and taxation and appoints ministers. Executive powers are exercised by a Chief Minister (and nine ministers) through the Council of Ministers.

While the legislative context is not directly comparable to Aberdeen City, there are a number of lessons relating to the Panel that could be adapted in an Aberdeen City context in relation to the Council's issue of bonds. Jersey issued bonds in 2014 to fund social housing which was and, like Aberdeen, dependent on a credit rating. The State's credit rating was directly influenced by:

- The assurance provided by the Fiscal Policy Panel;
- Transparency of a strong balance sheet position including a robust framework around reserves;
- Stability around Medium/Long Term Financial Planning including underlying business cases on specific large projects within the overall capital Programme.

The Panel was established before the bond issue, but is now an indirect part of the credit rating process. It produces an annual 'state of the economy' report, and this, and the Panel's work, provides an independent assessment to the credit ratings agency six-monthly report. In this sense the ratings process is informed by and benefits from an independent and credible validation of policy and the 'state of the nation' with regard to the economy.

It was established to provide Jersey's Treasury & Resources Minister with independent economic advice on matters relating to tax and spending policy. It is an independent and advisory body accountable to the Minister of Treasury & Resources, and does not make policy decisions.

In this sense its sphere of influence is indirect, and relies on the robustness and independence of its analysis and advice, in a fully transparent process. It publishes its report, annually, in August each year. This usually covers the strength of the local economy and outlook; comments on the State's financial position; recommends policy on a Stabilisation Fund

A strategic reserve has been kept aside with the capital value used in exceptional circumstances to insulate the island from structural economic decline (eg industry collapse); a stabilisation fund applies to the Island's fiscal policy with proposals for tax and spending, withdrawals from/ payments to lying with the Treasury. When the Stabilisation Fund is at sufficient levels, the panel decides when payments are made to the Reserve.

The Fiscal Policy Panel's work is guided by five key principles:

1 Economic stability is at the heart of sustainable prosperity;
2 Fiscal policy needs to be focused on the medium-term;
3 Policy should aim to be predictable, with flexibility to adapt to economic conditions to assist in creating a more stable economic environment;
4 Supply in the economy is as important as demand; and

5 Low inflation is fundamental to the competitiveness of the economy.

It is a group of three independent and professional economists with extensive experience in policy making. The Panel is guided by its understanding of the preferences of islanders in making its recommendations. They believe that islanders want the States to be prudent and create the conditions for economic growth while respecting the island's cultural heritage, maintaining the competitiveness of the economy and keeping inflation low. The work of the Panel is directly supported by an Economic Adviser and team of economists that undertake the analysis for the work of the Panel. Panel Members themselves undertake quarterly visits to the islands to meet with businesses and stakeholders to corroborate the work of the economist team.

The development of an 'independent panel of experts' for Aberdeen City could provide an annual reporting system on the performance of the place to support the ongoing monitoring of Aberdeen's performance in UK and international financial markets. It could also support the annual credit rating process provide independent commentary on some of the policy effects around securing new fiscal powers to the Council. Other benefits of the Panel may include the independent scrutiny and added value to the overall governance process and decision-making. The Panel could provide advice on how public funds are utilised to drive economic growth and the use of strategic reserves.

Discussions with the State of Jersey's Economic Development officials also indicate that critical to the success of the Panel, as well as its independence, is the resource (Panel Members) and the support behind it. If the Council wanted to develop the consideration of an independent Fiscal Panel for Aberdeen City, expertise in the following areas could be sought:

- Oil & Gas economics
- Institutional investment
- Higher education
- Government economic adviser

5.9.2 SUPPORTING THE ANNUAL CREDIT RATING RE-ASSESSMENT – FINANCIAL MANAGEMENT

Moody's described the financial management of the Council as having a "strong track record on financial performance" and Audit Scotland in its 2015/16 external audit report also described the Council's financial management as "sound financial management". The Council will be expected to continue to strengthen it financial management arrangements as they are an important feature of the annual credit re-assessment. In addition, the Council will also need to present some of its existing financial information in different ways in light of the new interest from the credit rating agency and the bond investors.

Financial Planning (Budgeting)

Changes to the Council's Financial Planning will include:

- The annual budget will need to be presented showing the gross expenditure (as opposed to net);

- The budget statements will pay due cognisance to the Council's Balance Sheet;

- The Council requires to report on it's key financial metrics (over and above the prudential indicators) and these will be developed as Key Performance Indicators;

- The budget will also cover the key Treasury Policies, strategies and statements for the forthcoming medium term; and

- The budget now requires to include both the short, medium and long term aligned with delivery outcomes to ensure the Council has a long term sustainable balanced position as required by the Local Government (Scotland) Act 1973.

Financial Monitoring

The Council traditionally has reported it's financial position to the relevant service committees followed by a report showing the overall financial position. In order to comply with the new regulatory framework a review is ongoing to determine if this continues to be appropriate. It is likely that the following (which is unlikely to be exhaustive) will be required:

- The Council should now report on a quarterly basis to Finance Policy and Resources on the financial position of the Council;

- Reporting to service committee's is likely to be after reporting to FP&R. That is, the council position will be reported first and then subsequent reporting to service committees will follow to ensure that the financial position can be reported to the London Stock Exchange;

- Such financial reporting will include financial statements showing the Income and Expenditure position as well as the Council's Balance Sheet;

- The Council's key financial metrics used for the annual credit re-assessment will also need to be disclosed; and

- The financial reporting will need to examine the key projects which the Council is undertaking to understand any potential risk that the committee should be made aware of.

Financial Reporting

In moving to a new financial reporting methodology and system the Council will need to:

- Review its current year end processes and procedures to enable quarterly "Accounts" to be reported and considerably shorten the time it currently takes to complete the year end accounts;

- Determine how meaningful International Financial Reporting Standards (IFRS) is compliant/assists in the annual credit rating re-assessment – in addition to IFRS compliant accounts, the Council will need to consider whether non-IFRS compliant accounts would be a useful tool in financial reporting;

- The Council will also need to consider what additional information should be disclosed within the Annual Accounts; and

- Note that any changes to our in year and end of year accounts closedown approach will have potential Implication's for both internal and external audit.

Finance for Decision-Making

- All decision making reports to council and/or committees require officers to identify the financial implications associated with the proposed decision. Notices of motions and member amendments to officer recommendations are also reviewed in order to consider the financial implications of proposed actions. Processes for reviewing such notices and amendments, together with officer recommendations, will now need to be considered in light of the requirements and expectations of holding and maintaining a suitable credit rating and being an Issuer of Bonds.

Financial Governance

Under the regulatory framework the Council will need to review its Financial Regulations and wider financial governance arrangements. This will be done as part of the wider Governance Review that is ongoing but there will need to be in the short term the following actions to be undertaken:

- Undertake a review of any Person Discharging Managerial Responsibilities (PDMR) although it is unlikely that this will identify any individual within the Council given the unique nature and scale of the Bonds;

- Given that the Council is now required to comply with the LSE regulations consideration will need to be given to the need for an “LSE Compliance Officer”.

5.9.3 THE NORTH EAST PENSION FUND – INVESTMENT OPPORTUNITIES

There are legal restrictions which apply to any proposed investment (“NESPF”) which is due to the fact that NESPF administers the Pensions for the Council and therefore investment in the Council’s Bonds would be considered to be an employer related loan in the bonds by North East Scotland Pension Fund. These restrictions (referred to as the ‘self-investment restrictions’) are in section 40 of the Pensions Act 1995 and the Occupational Pension Schemes (Investment) Regulations 2005. This legislation was put in place by the UK government to regulate the economic exposure that occupational pension schemes have to the employer group. This legislation was developed to impose a regime of good governance on pension schemes. Prior to this, the general law which applied was in some respects unclear and there were incidents whereby pension funds were utilised to shore up financially unstable organisations which were unable to repay the funds.

6. IMPACT

Improving Customer Experience –
The bond provides a source of financing which allows part of the Capital Programme to be funded while diversifying the financial portfolio of borrowing to allow an element of long term flexibility within the portfolio.

Improving Staff Experience –
The ongoing requirements in relation to the credit rating and LSE listing requires that the governance around decision making and the processes that the Council adopts remains clear. This will allow employees and citizens to have a greater confidence in the decision making and actions of the Council.

Improving our use of Resources –
The index linked public bond provides the optimal solution as it delivers the lowest net present cost of debt service over the terms of the finance (38 years). The proposal allows a diversified financial portfolio of borrowing to allow an element of long term flexibility within the portfolio.

Corporate -
The bond allows the Council to part fund the Capital Programme and assist the Council in moving forward to achieve its objectives in line with the strategic infrastructure, Smarter City. Carrying out this funding places Aberdeen City Council at the forefront of creative lending solutions and drives Aberdeen City forward as a Council for the future.

Public –
This report may be of interest to the public as it explains part of the Council's proposed strategy to finance the Capital Programme which the Council wishes to pursue. It also explains the rationale for the Council obtaining a credit rating.

An Equalities and Human Rights Impact Assessment (EHRIA) has not been undertaken as this is not relevant to this project

A Privacy Impact Assessment (PIA) has not been undertaken as none of the proposed projects should impact on the privacy of any individual

7. MANAGEMENT OF RISK

Maintaining Credit Rating

7.1. The Council must endeavour to maintain a suitable credit rating and insofar as within the Council's control that the Credit Rating is maintained at Aa2, which is one notch below the UK Government. Should the credit rating fall the liquidity of the Bonds in the secondary market will drop. Bondholders if concerned may call a meeting which would analyse the Council's financial position and the Council are obliged to respond honestly to all questions. Further, if the credit rating falls so that it is three notches below the UK Government then the Bondholders may request repayment of their proportion of the Bonds held.

7.2. In addition if the Credit Rating falls then the Council's ability to obtain other financial products in the market place may become more expensive and/or difficult to access. This is due to the perceived risk in investing in a lower Credit Rated body with some investors such as pension funds having mandates to invest within certain credit rating bands (which represent the perceived risk of the investment). In addition while a local authority the Credit Rating will be examined by other lenders and if they consider that there is an increased risk in lending then the availability/cost of lending may be negatively impacted.

7.3. These issues may be mitigated by the Council putting in place and maintaining robust governance around capital projects and price sensitive information to ensure that the Council is able to react promptly to commercial situations arising from the various capital projects and address these promptly to ensure that these projects are delivered in a timely and cost efficient manner. This can be achieved by incorporating the additional requirement from the Credit Rating and London Stock Exchange into the Corporate Governance Review which will require among other things a full review of the Financial Regulations.

8. BACKGROUND PAPERS

CG/16/150 - Financing Strategy for the Capital Programmes

9. REPORT AUTHOR DETAILS

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