STATES OF JERSEY

FUTURE HOSPITAL: REPORT ON UNDERTAKING BORROWING FOR THE FUTURE HOSPITAL WITH CAPITAL REPAYMENTS MADE IN TRANCHES

Presented to the States on 1st March 2018
by the Minister for Treasury and Resources

STATES GREFFE

REPORT

THE FEASIBILITY AND COSTS OF UNDERTAKING BORROWING FOR THE FUTURE HOSPITAL ON THE BASIS THAT CAPITAL IS REPAID IN TRANCHES, AS REQUIRED BY P.107/2017 (AS AMENDED)

The approval of P.107/2017 on 13th December 2017 included an amendment from Senator P.F.C. Ozouf (P.107/2017 Amd.(3)), which reads as follows –

"(d) to request the Minister for Treasury and Resources –

(i) to undertake a review of the feasibility and costs of undertaking any borrowing on the basis that the capital amount borrowed is repaid in tranches over the intended life of the new General Hospital rather than in a single lump sum on final maturity; and

(ii) to report the outcome of such review to the Assembly no later than 28th February 2018;"

This report provides the conclusions of the review.

Recommended Funding Strategy

The Treasury and Resources Department engaged with external expert advisers and the Treasury Advisory Panel to assist in evaluating the financing options. The Treasury Advisory Panel ("TAP") is established by the Minister for Treasury and Resources to advise him, the Assistant Minister and the Treasurer of the States on matters relating to investment decisions, and may also be requested to provide advice on other relevant Treasury matters. The Panel comprises –

- an Independent Chairman – Philip Taylor;
- the Treasurer of the States of Jersey; and
- up to 3 Non-Executive Members (currently 2) – Gordon Pollock and Paul Dentskevich.

The TAP has provided advice to the Minister in the context of the decision to limit the borrowing to up to £275 million. After careful consideration of the options available, the recommended strategy for the construction of the hospital brings together multiple funding sources into what is known as a blended solution. This solution includes issuance of a public rated sterling bond with a single repayment of the principal capital sum borrowed at maturity (generically referred to as a bullet repayment), supplemented by existing reserves.

The rationale behind the decision to choose this form of external debt is driven by a number of factors –

1. It is by far the most flexible solution. It provides the maximum protection of the Strategic Reserve so that it is available for alternative uses should it be needed. For example in times of crisis, national emergency or severe economic recession funds will be readily available from the Strategic Reserve without

having to resort to borrowing (if at all possible) at an unfavourable time on unfavourable terms, or alternative sources of funding which may take time to develop (e.g. taxation, sale of other assets).

2. Long-term fixed rate funding is available that matches the projected life of the asset (30 to 40 years). The full requirement can be raised in a single fundraising without maintenance covenants or material restrictions. The States credit rating is AA- and this coupled with the anticipated issuance size of up to £275 million would be sufficient for the bond to be of benchmark size and included in the majority of market indices – thereby generating demand.

3. Long-term interest rates are currently at relatively low levels and the States will be able to take advantage of these and provide cost certainty over the full life of the debt.

4. Providing the maximum protection of the Strategic Reserve, with long-term expected annual returns of at least 5% over the life of the borrowing, provides sufficient returns to pay both the interest on the bond and the principal at maturity.

5. The States has previously approved and experienced this type of bond issuance and the ongoing operational requirements.

It follows that any alternative solution would need to represent a significant improvement on these factors in order to be considered.

Background

In preparing for the original Proposition P.130/2016: Future Hospital Funding Strategy, significant work was undertaken to advise the Minister for Treasury and Resources about the various options available for borrowing to fund the construction of the Future Hospital.

At a very basic level, there are 2 broad options when considering funding requirements for large capital projects such as the construction of a hospital – use existing reserves or look to external options. The key considerations when assessing internal or external financing are –

- The scale of financing required – are sufficient reserves available to afford the total cost?
- Costs of the funding solution – it is assumed the new hospital will not generate significant additional income, so the opportunity cost of using existing reserves and interest costs of external options need to be compared, including how to meet such costs.
- Repayment requirement – if external debt is used, a sinking fund or other future funding solution will be required to repay the amount borrowed.
- Certainty of funds – whether the solution is external or internal funding, the sum of money will need to be ring-fenced to ensure the money is available when required.
- Debt to Gross Domestic Product (GDP) – it is important for the Island to be able to demonstrate the strength of our economy to other

jurisdictions. Debt to GDP is a widely-recognised metric for investors who are assessing a country's ability to meet its liabilities and therefore its economic strength.

- Currency required – it is difficult to predict with certainty which currency will be needed to pay for building the new hospital until a contractor has been decided upon. As a funding strategy is required ahead of any contracts being in place, it is assumed at this stage that the majority of costs incurred will be in Sterling, and that any currency hedging considerations will be made at a later date, as construction plans become clearer.

Option 1 – Using existing reserves

There are only 2 reserves that have large enough balances to fund the construction of the new General Hospital: the Strategic Reserve Fund ('the Fund') and the Social Security (Reserve) Fund.

It was considered inappropriate to use the Social Security (Reserve) Fund as it represents a contract with its contributors; it is a key part of the strategy for managing the pressures arising from an ageing population, and is the mechanism by which contribution rates are smoothed over time, effectively acting as a buffer against the rising burden of pension costs.

The current policy on the use of the Strategic Reserve's capital balance is restricted to exceptional circumstances caused by severe structural decline or major natural disaster, or specifically in relation to the Bank Depositors Compensation Scheme (limited to £100 million).

In the Budget 2014, the States Assembly approved the amendment of the Strategic Reserve policy to include "that the Fund may be used for the planning and creation of new hospital services in the Island". Furthermore, the States has previously agreed that the capital value of the Strategic Reserve should be maintained at the real terms value of the balance at the end of 2012, which was £651 million. This means the protected amount increases annually by the Jersey Retail Prices Index ('RPI(Y)').

P.107/2017, as approved, varies the 2014 decision and asks that the Fund's policy be further amended to authorise –

a. That the costs of borrowing and ongoing finance and administration costs related to the borrowing be borne by the Strategic Reserve Fund.
b. The repayment from the Strategic Reserve Fund of the amount borrowed.
c. Any unspent monies shall be returned to the Strategic Reserve Fund.

Withdrawals from the Fund to cover the cost of construction of the hospital will likely reduce the level of capital upon which returns can be made and reduce the value of the Fund below the current protected capital value for approximately 25 years. Before utilising the Strategic Reserve consideration should also be given to the opportunity cost and forgone investment returns. Lastly, borrowing costs are still significantly less than the historic returns on the Strategic Reserve, which leads to the conclusion that it would be more appropriate to use debt funding rather than draw down reserves.

Option 2 – External financing

There are a number of options to obtain external financing, including, but not limited to –

- Rated Public Sterling Bond
- Retail Bond
- Private Placement Notes
- Bond Ladders
- Asset Backed Commercial Paper
- Project Finance
- Bank Finance
- Prudential Borrowing from the UK Public Works Loan Board (“PWLB”)[*]

A table summarising most of these solutions is contained within the Appendix of this report.

Response to the amendment

The rated sterling public bond market is the primary debt market for sovereign issuers both large and small. The States of Jersey’s existing bond was issued in this market in June 2014 and in common with the vast majority of rated sterling public bonds, it is scheduled to make a bullet repayment of capital to investors on the final maturity date in June 2054.

Repaying the capital amount in tranches over the intended life of the new General Hospital, rather than in a single lump sum on final maturity, could be achieved in a number of ways. Some of these have been explored previously when considering the optimum source of borrowing, whereas further advice has been taken on new options.

The alternative options for which advice has been received were –

- Euro Medium Term Note (EMTN) Programme.
- Private Placement Notes.
- Public rated bond with an amortising profile.

The key features of each option together with an affordability analysis are detailed below.

<u>Euro Medium Term Note Programme</u>

- Established to issue debt utilising a common platform and terms, at a range of different maturities and different tranche sizes.
- Issuance can range from a few months through to 30 years.
- Debt issuance governed by legally binding agreements.
- Usually utilised by large corporates or financial institutions seeking to raise debt frequently.
- Simplifies debt issuance for borrowers.

[*] The States of Jersey is not eligible to access the UK PWLB as it is considered as a UK crown dependency and not a local authority

An EMTN programme is simply an “umbrella document” which allows for multiple issues from the same basic documentation. These issues could be benchmark size (£250m+) or much smaller private placements of £20 million–£30 million. In theory this could be a good way of issuing multiple maturity tranches, however in practical terms this is unlikely to work or be efficient –

a. There are only a handful of UK institutional investors who will (sometimes) participate in private placements of this type.
b. The vast majority of investors prefer the greater secondary market liquidity offered by public sterling bond issues.
c. If the States were able to create a staggered maturity of placements in this way it would be inefficient and expensive. Investors would require a significant pricing premium over a public bond because of illiquidity and lack of pricing tension between investors.
d. It is a process which may take up to 2 years to find 5 or 6 investors to take approximately £50 million each, by which time Gilt yields and credit spreads could be very different.

For these reasons an EMTN programme has been discounted as a viable means of achieving the funding requirements with any certainty over timing or ultimate execution.

Private Placement Notes

- Issuance of debt to an investor in the format of a security or loan which is not listed on any recognised exchange.
- Typically for tenors between 7 and 30 years, issuance can be ‘one off’ or multiple, but each issuance needs to be marketed separately.
- No credit rating required and debt is typically held to maturity by investors.
- Usually the debt is repayable at maturity and amortising repayments are rare.

The Private Placement market is dominated by US investors, however there are a small number of UK investors who also invest to a greater or lesser degree. The latter are generally the same investors who operate in the Sterling public bond market. These investors are comfortable with the concept of amortisation and multiple issues at different maturities creates synthetic amortisation. However, there are a number of disadvantages to this type of debt issuance –

a. There is a small investor base who will tend to dictate the debt terms in line with their investment appetite rather than the States preferred maturity.
b. The majority of investors are based overseas (United States) and are likely to require indemnities for any cross currency swap taken out by investors to provide Sterling proceeds, in the event that the States choose to repay the debt early. Such indemnities will require the States to ‘make good’ any loss suffered – a potential loss which is hard to quantify.
c. Given the need for overseas investors to mitigate their currency risk this may well reduce the maturity which they are willing to go out to.

d. Investors will require a price premium to mitigate the additional illiquidity and other risks making the overall cost of issuance higher than a rated public sterling bond.

For these reasons Private Placement Notes have been discounted as a viable means of achieving the funding requirements at the cheapest cost and with the ultimate degree of flexibility.

Public bond with an amortising repayment profile

- Benchmark issuance size of £250 million.
- Less common than bullet repayment bonds.
- Often issued linked to specific projects, with the repayment profile linked to the project life.
- Amortisation usually commences at the end of year one with equal capital repayments over the term of the bond (similar to a mortgage).
- Limited pool of investors, with no previous known precedent of sovereign amortising bond issuance.
- Bond tenor can be linked closely to the life of the asset.

Amortising bonds in the rated sterling public bond market are much less common than bullet repayment bonds. Of the 140 investment grade bonds issued in the last 3 calendar years only 8 have an amortising profile (source: Deallogic). This creates uncertainty around the level of investor appetite when marketing the bond and may require a ‘fall back’ option of issuing a bullet repayment bond. In practical terms this creates a number of disadvantages –

a. A reduced investor pool which creates risk to completing the bond issue on the terms required by the States.
b. There are no real known precedents of sovereign issuers attempting to launch amortising bonds as a ‘standard offering’.
c. The lack of certainty about the final profile of the bond repayments makes hedging market risk prior to issuance complicated and potentially costly.
d. There is the potential that investors may require a premium over the expected price of a bullet repayment bond, this would only become clear during the marketing process, thus creating risk to the final cost.

For these reasons a public Sterling rated bond with an amortising repayment profile has been discounted as a viable means of achieving the funding requirements with any certainty that the final maturity profile will reflect what the States wished to issue at the outset.

Affordability Analysis

The main difference between the proposed solution and an amortising repayment schedule is that the latter commits the States of Jersey to making known capital repayments to investors at pre-agreed dates. The proposed bond only requires a single repayment of capital to investors at the final maturity date.

Amortising the debt repayments over the life of a bond issue (or through EMTN or Private Placement issuance) puts pressure on the Strategic Reserve to provide consistent

investment returns from the outset. Furthermore, liquidity will be required to meet the financing of the regular interest costs and capital repayments. This liquidity would lead to a change in investment strategy which will consequently lead to a reduction in expected investment returns.

If insufficient investment returns are achieved then it would be necessary to utilise the capital from the Strategic Reserve to meet the regular payments, which has the knock-on effect of reducing the value of reserves available to create sufficient returns to meet future commitments.

A bullet repayment was chosen because it provides a better opportunity to absorb fluctuations in investment returns. Modelling by the States investment adviser suggests that it is prudent to expect a return of RPI + 2% over a period of at least 30 years which allows the current value of the Strategic Reserve to meet the semi-annual coupon payments and create sufficient returns to meet the capital repayment at maturity.

In the event that investment returns are appearing to be insufficient to meet the capital repayment this will become clear towards the latter stages of the bond tenor and consideration could then be given to the disposal of other strategic assets if required.

An alternative solution is to re-finance maturing debt as and when repayments fall due. This exposes the States to ongoing re-financing risk with the level of interest rates at the time of such re-financing completely unknown today. In the event that the States chooses not to re-finance maturing debt, or make repayments from reserves, it will need to identify other sources of funding (e.g. asset disposal) to meet the capital repayments due.

With a bullet repayment bond the capital repayment only falls due on the maturity date. This protects the current value of the Strategic Reserve and, based on investment advice, will allow it to accrue sufficient capital to pay back the debt at maturity. This removes any potential re-financing risk and defers any decision to dispose of other assets, if required, until the final maturity date of the bond.

Comparison of funding options

	Public Rated bond – Vanilla	Public Rated bond – amortising	Private Placement Notes
Issuance Size (£275m)	Yes – size is above the benchmark required	Yes – size is above the benchmark required	Yes – no benchmark
Tenor	30 to 40 years	30 to 40 years	Individual placements maturing every 5 years
Pricing	UK Gilts + 100 bps	UK Gilts + 100 bps	UK Gilts + 110-120 bps (10Y) up to UK Gilts + 125-135bps (30Y)
Financial covenants	None – same as current bond issue	None – same as current bond issue	Yes – likely to include covenants linked to specific events, e.g. credit rating trigger
Credit rating required	Existing S&P rating	Existing S&P rating	No
Advantages vs. alternative options	✓ No financial covenants or onerous restrictions ✓ Lower coupon than private placements ✓ Longer maturities available ✓ Greater market liquidity versus private placement ✓ Lowest execution risk versus private placement ✓ Cost defeased over time, by increase in value of Strategic Reserve	✓ No financial covenants or onerous restrictions ✓ Lower coupon than private placements ✓ Longer maturities available ✓ Greater market liquidity versus private placement ✓ Lowest execution risk versus private placement ✓ Pays the debt back over time versus material refinancing event at maturity	✓ Repayments spread across maturities ✓ Low issuance costs ✓ No credit rating ✓ Deferred drawing possible
Disadvantages vs. alternative options	× More expensive to issue than private placement × Single capital repayment at maturity carries risk if funds not available to finance × No deferred drawing possible	× More expensive to issue than private placement × Ongoing cash drain on reserves via repayment profile versus single capital repayment	× Fewer likely investors – with higher influence over the States in times of challenge × Higher cost than public bond × Financial covenants and

		✘ Higher execution risk than non-amortising bond ✘ Will not attract maximum market liquidity appetite ✘ Heightened affordability issues if the Strategic Reserve does not generate sufficient returns	other limitations likely to apply ✘ Higher execution risk in timeframe ✘ Ongoing re-finance risk if returns on the Strategic Reserve are insufficient to repay debt as it matures ✘ Doesn't lock in lowest cost of financing for the very long term ✘ Future interest rate risk if re-financing required

CONCLUSION

Following this review the Minister for Treasury and Resources concludes that funding the borrowing element for the construction of the new General Hospital is still best achieved through the issuance of a single public rated sterling bond with a bullet capital repayment. This provides certainty over the cost of funding and a debt maturity which matches the life of the asset. The Minister believes that this will maintain the Strategic Reserve at a level which provides appropriate protection against future economic shocks. In addition, the Strategic Reserve will be able to generate the required level of return to repay the bond at maturity, or before.

Whilst an amortising repayment profile is feasible, the advice sought demonstrates that on a direct cost comparison basis solutions such as Private Placement Bonds and an EMTN programme are more expensive than a public rated sterling bond. Whilst advice suggests that no additional credit spread will be payable for an amortising bond structure, the Minister is aware that this type of deal represents a very small percentage of the overall market, which leads to a smaller investor base. The success of bond issuance generally rests on getting the broadest possible participation from investors and whilst an amortising bond could be initially presented to the market, there may be a need to default to a bullet style transaction if investor demand is muted.

In addition to the direct costs of issuance, there is significant opportunity cost to issuing debt with an amortising repayment structure. There will be pressure on the Strategic Reserve to provide consistent investment returns from the outset. Furthermore, liquidity will be required to meet the financing of the regular interest costs and capital repayments. This liquidity would lead to a change in investment strategy which will consequently lead to a reduction in expected investment returns.

In the event that investment returns are insufficient to meet capital repayments as they fall due consideration will need to be given to drawing directly from the Strategic Reserve or to the disposal of other strategic assets if required. An alternative would be to re-finance maturing debt as and when repayments fall due. This exposes the States to ongoing re-financing risk with the level of interest rates at the time of such re-financing completely unknown today.

Following the decision to decline planning permission for the original project, the States continues to be exposed to movements in underlying interest rates. The Treasury and Resources Department continue to monitor these underlying interest rates whilst awaiting the outcome of the review of the building plans, which will need to be completed before Ministers can proceed with borrowing.

APPENDIX

Summary of external financing options

	Public Bond (rated)	Retail Bond (listed)	US Private Placement	Project Finance	Bank Debt
Currency	GBP, EUR, USD, others	GBP, EUR, USD	USD, GBP	GBP, EUR, USD	GBP, EUR, USD
Liquidity capacity	£250m+ (could go lower with an illiquidity premium)	£50 - 200m	£25-500m	£50m+	£20m+
Maturity	5-50 years	3-10 years	3-30 years	5-25 years	1-7 years
Financial covenants	Typically none	None	Typically bank style covenants	Required, typically cashflow driven	Yes
Credit ratings	Minimum one required	Not required for issuance but typically preferable	Private ratings may be required	Not required	Not required
Inflation-linked	Direct is an option	Direct is an option	Direct is an option	Via swaps	Via swaps
Investor relationships	No	No	Yes	Yes	Yes
Pros	✓ Deep and liquid market ✓ No financial covenants ✓ Historically attractive fixed coupon cost ✓ Long tenors available ✓ Benchmark issue lays ground for future issues	✓ Access to alternative investor base ✓ No financial covenants	✓ No public credit rating required ✓ Historically attractive fixed coupon cost ✓ Flexible maturities available ✓ Delayed drawdown possible	✓ Non-recourse debt ✓ Suitable for investment capex where there is a construction period ✓ Flexibility in draw down and repayment profiles ✓ Has been previously structured to be off balance sheet	✓ Simple to arrange ✓ Flexibility in draw down and repayment profiles
Cons	× Public credit rating and ongoing disclosure requirements × £250m benchmark issuance size × Early redemption costs	× Bespoke disclosure and documentation requirements × Less capacity than public market × Shorter tenors than alternatives	× Financial covenants required × Early redemption costs × Typically more costly than public markets × Long dated swaps would be required	× Security required × Can be complex in structuring × Lengthy arrangement process × Financial covenants required × Amortisation required typically	× Shorter tenors than other markets × Refinancing risk × Financial covenants required
Pricing	30-40yrs G+87-92bps	10yrs 4.50-5.00%	10-30 yrs G + 110-140 bps	25 yrs 175-225bps*	1-7yrs 70-85bps

**Pricing based on assumed non-recourse structure with limited to no guarantee from States of Jersey*

Source: EY (Pricing as at 17 October 2017)