WEST DUNBARTONSHIRE COUNCIL

Report by the Executive Director of Housing, Environmental and Economic Development

Council: 26 October 2011

Subject: Securitisation of the Council's Non-Operational Estate's Portfolio

1. Purpose

1.1 The purpose of this report is to inform Council of the progress that has been made in relation to the Securitisation Project and to gain approval to take forward the recommendations within this report.

2. Background

2.1 On 26 January 2011, the Council agreed to develop a Detailed Business Case with an alternative business model and subsequent fundraising proposal in relation to securitising the Council's Non-Operational Property Portfolio with a view to obtaining an investment fund of £35m. At that meeting Council gave approval for Officers to procure external advisers by tender, under the terms of the Catalyst Procurement Framework, to prepare a Detailed Business Case for the project and thereafter providing the detailed business case does not reveal any significant changes to the viability of the project as detailed in the business case (in which case a further report should be made back to Council) to invite the investment market to put forward their best terms by way of a funding competition to provide Debt Finance to the LLP. Following the tendering exercise, Grant Thornton, were appointed as our new advisors, supported by Pinsent Mason, Solicitors and CBRE, Property Advisors.

2.2 On 29 June 2011, the Council considered a further report, informing Council of the investment projects which had been developed to outline business case, which would benefit the Council by improving the delivery of its services and/or revenue costs and could be funded from either the existing Council's General Services Capital Funds, the Council's Modernisation Fund, Spend to Save Budgets and/or monies raised through the Council's Securitisation Project. The report also sought approval to develop these projects into Detailed Business Cases which would be submitted to Council for consideration at the end of this year. The Council agreed to all the recommendations contained within that report.

2.3 The Advisory Team began working in March 2011 with Council Officers on developing and preparing the Tender Documentation and Memorandum of Information which would be issued to all interested potential funders when the funding competition took place.

2.4 In addition, the Advisory Team have provided Legal, Financial and Property Advice to Council Officers on establishing a Limited Liability Partnership arms-length company (the LLP). This advice has covered the governance of such a company, including TUPE, the LLP Members Agreement, a Business Transfer Agreement, identifying the scope of services transferring from the Council to the LLP and the identification of services such as HR Support, premises and ICT support which the LLP would wish to purchase from the Council. The documents take account of the recommendations of Audit Scotland contained in their report on 'Arms Length External Organisations' which was reported to Council in September 2011. The legal documents are nearly complete and the company is ready for incorporation as soon as it is required.

2.5 The Financial Lead of the Advisory Team (Grant Thornton) met with various Financial Institutions between February and May 2011, to explain the project and the Council's wish to raise Debt Finance from the rental performance of our Non-Operational Estates Portfolio. The Funding Competition to the Financial Markets was originally scheduled to take place between June and August 2011. Based on feedback received, it was felt that there was an improved chance of achieving a more competitive financial agreement if the competition was moved from the summer months avoiding holiday commitments to allow all of the institutions to submit competitive, well structured proposals. It was envisaged that the funding competition would be moved to August 2011 to October 2011.

3. Main Issues

3.1 As mentioned at 2.2 earlier, investment projects are being developed to detailed business case stage which it is expected will be submitted to the Council at the end of this calendar year.

3.2 All draft detailed business cases will be submitted to the Strategic Asset Management Group by the 11 November 2011. The detailed plans will then be presented to a "Challenge Panel" made up of the Corporate Management Team who will test the rigour of each business case and suggest areas for improvement or further detailed work by the project team charged with developing the Detailed Business Case. At this stage in the process it will be clear which projects have Detailed Business Cases which are sufficiently robust to be considered at the December Council meeting.

Those Detailed Business Cases deemed by the Council's Corporate Management Team not to be ready for the December 2011 Council meeting will be presented for consideration as early in 2012 as possible. A Members' briefing session focussed on those projects with Detailed Business Cases being submitted for consideration at the December Council meeting will be arranged late in November 2011.

3.3 Within the Council's Financial Strategy 2011/12 to 2020/21 (as reported to Council in August 2011), the budgeting analysis assumed a "Go Live" date for the LLP of 1 January 2012. The Council's 2011/12 General Services Revenue budget assumed a loss of income of £0.626m and a full year loss in 2012/13 provided for at an estimated £2.7m.

3.4 Closer examination of the Outline Business Cases submitted to Council on the 29 June 2011 showed that the investment finance required for all of the projects (including those which were recommended not to be funded from the securitisation funding) would be required over the first 4 years of the projects as follows:

- By the end of Year 1 £5.6m
- By the end of Year 2 £7.9m = £13.5m in total
- By the end of Year 3 £14.7m = £28.2m in total
- By the end of Year 4 £6.5m = £34.7m in total

3.5 It is clear that, due to the nature of the projects and the lead in time required by many of them, the Council will not require access to all of the potential investment funding of around £35m immediately.

3.6 Officers have examined options whereby the Council could use the £35m in different ways in the interim period between the date of drawing it down from the lender and the planned phased spend of the funds (per the bullets at 3.4 above). These options revolve around using the funding to offset existing debt thereby reducing interest repayments and in relation to the timing of the draw-down of the funding.

Option One

3.7 The first option would see the Council drawing down the full £35m planned and using the funds to temporarily offset the Council's borrowing and treasury management requirements in the interim period. Drawing the £35m down and utilising the debt finance in this way over the 48 months of phased expenditure (as shown at 3.4 above) changes the net cost to the Council of securitising the income. This equates to an annual financial effect on the general fund as follows:

2011/12	£0.561m
2012/13	£1.733m
2013/14	£1.814m
2014/15	£2.349m
2015/16	£2.687m

3.8 The above analysis shows that for each of the years identified the lost rental income is partially offset by reduced costs of borrowing requirements on the Council as the £35m funding raised through securitisation is utilised rather than normal borrowing processes. In year 2016/17 the full £2.7m reduction would be felt as the full value of the £35m investment funding would have been expended on the approved projects. By 2015/16 it is expected that revenue efficiencies arising from the projects being implemented would start to be received (based on the analysis presented to Council on 29 June 2011).

Option Two

3.9 The second option which may be available to the Council is to have a phased draw-down arrangement reflecting the expected funding requirements over 48 months put in place with the preferred lender. This model would reduce the immediate loss of £2.7m revenue income in any one 12 month period. However, any funding institution will apply a commitment fee of around 0.6% of the funding being reserved at any time. The Council's Financial Advisers advise that this model may be available, however they have no experience of it operating widely and it would only be through the funding competition that the Council would establish whether lenders have an appetite for such an arrangement. Such an arrangement would reduce the effect on the Council's general revenue account to the following additional cost:

2011/12	£0.052m
2012/13	£0.541m
2013/14	£1.138m
2014/15	£2.324m
2015/16	£2.742m

Similar to the first option the above analysis shows the net revenue effect on the general fund over the period covered.

Option Three

3.10 The third option considered the possibility that the investment projects currently being developed will not require £35m to be invested. In fact, as was agreed at Council on 29 June 2011, a number of the investment projects identified as outline business cases will not be funded from this funding source. There is therefore a doubt around the total maximum level of funding that will be required for the projects and this will become clearer once the detailed business cases have been finalised.

Given this possibility it may be more sensible for Council to consider a third option of delaying the income securitisation until after the detailed business cases are considered by Council. At that point a review of the required level of income to be securitised would take place with a funding competition for the identified required amount being undertaken during 2012/13 aligned more appropriately to the timing of the expenditure being made from the funds.

3.11 The ability to raise funding from the market through the securitisation process is affected by a few key issues as follows:

- The willingness of the market to lend

  This is particularly sensitive to national and international economic cycles. Members will be aware of the current concern internationally around sovereign debt and the potential for countries such as Greece to default on debt repayments. Such an event could significantly destabilise lending institutions and significantly reduce the supply of investment funding. On the other hand action by national and international governments and banking institutions such as the Bank of England to use quantitative easing will tend to increase the money supply to encourage lending institutions to lend.

- Interest rates

  The value of funding generated through a securitisation process will be affected by the interest rates in play at the time that the deal is done in the money market. The higher the interest rate then the higher the cost of borrowing the investment funding. This will have the effect of increasing the net cost of the income securitisation from the £2.7m figure identified in the January 2011 report to Council. In addition there is a potential that this would also reduce the profitability of the LLP and therefore its ability to reinvest in the estate to the extent that was identified in the original business case presented to January 2011 Council.

4. People Implications

4.1 During the period involved in the preparation of the detailed business cases a significant amount of officer time has had to be allocated to enable robust business cases to be prepared.

4.2 The Council has allocated all of the £250k sum approved at the 29 June Council meeting for external advice to assist the project teams develop the detailed business cases.

4.3 There are no other people issues in relation to this report.

5. Financial Implications

5.1 The issues raised above with regard to the timing of the spend of the investment funding generated and therefore the timing of the process to raise the funding through the securitisation process has financial implications for the Council.

5.2 Securitising the income stream ahead of the likely spend of the funding will result in a cost to the Council as the use to which the additional funding can be put to will not cover the cost of raising the funding. Sections 3.4 to 3.9 above explain this in detail.

5.3 The current budgetary planning assumptions for 2011/12 onwards take account of the effect of the lost income arising from the income securitisation, with £0.626m built into the budget for 2011/12 and the full £2.7m built into the draft budget affecting 2012/13 onwards.

5.4 There is an expectation that the projects being developed will achieve revenue savings, however due to the likely timescales of implementation it is not expected that these savings will be generated until year 4 of the projects (based on the Outline Business Case information presented to Council in June 2011).

5.5 At present the likely funding gap for the next 2 years, per the current Financial Strategy is as follows:

2012/13 £7.156m

2013/14 £12.618m

<u>Financial Assumptions</u>

5.6 The effect of the issues identified in section 3 above is that the Council's Financial Strategy requires to be revised. The value of the revision will depend on what assumptions are made regarding the options available to Council. It is recommended that the following assumptions are used in revising the Financial Strategy:

- Due to the significant level of doubt regarding the amount of funding that is required to be raised to fund the potential investment projects, that Council decides to delay the securitisation process until April 2012 with a planned drawdown on 1 October 2012; and

- Due to the fact that the Financial Advisers are in some doubt that the second option available around a phased draw-down of the funding arising from securitisation, that the financial effects identified for option 1 (at 3.7 above) are used to update the Financial Strategy.

5.7 The effect of the first assumption is to:

- Delay the income securitisation process in order to draw-down the funding by 1 October 2012, based upon the outcome of Council's decisions relating to the detailed business cases on the potential investment projects which are currently being developed; and

- Shift the financial effect of the lost rent until midway through 2012.

5.8 The effect of these assumptions is therefore to remove the assumed lost rent income within 2011/12. In addition the effect on 2012/13 and 2013/14 is to reduce the financial effect in the Financial Strategy to:

2012/13 £0.280m

2013/14 £1.733m

This has the effect of reducing the originally identified funding gap for these two financial years to:

2012/13 £4.736m

2013/14 £11.651m

5.9 It should be noted that in relation to the alternative use of the expected £35m that this effect can only be achieved by using the funding to offset Council borrowing requirements at that time. If Council does not have borrowing requirements at the time of receipt of the £35m then the net cost will increase.

5.10 Balanced against the above model and assumptions is the fact that interest rates are at present low and any delay in striking a securitisation deal runs a risk that when the securitisation takes place interest rates will be higher, thereby increasing the net effect of the income securitisation from £2.7m. It is expected that for every 0.25% of increase in the interest rate that the additional cost to borrow would be £87,500 per annum.

6. Risk Analysis

6.1 This report primarily deals with the timing of the funding competition. Based on present estimates it is unlikely that many of the projects will be sufficiently advanced to proceed until before the second half of 2012/13. The effect of both options identified above regarding draw-down options is to significantly reduce the financial effect on current assumptions in generating estimated funding gaps over the next two years.

The main risk to these assumptions relates to the Council's need for borrowing over the period covered. It is expected that there will be a need to borrow over the next two years linked to projects for Dumbarton Academy and the recently approved new Council Houses. However delays in these projects would have an effect on the assumptions in the report above. Officers will require to monitor the position regarding borrowing needs on an ongoing basis to maintain an overview of possible effects on the assumptions identified above and the effect on the Financial Strategy.

6.2 Another risk is that interest rates could rise and increase the overall cost of borrowing. To mitigate this risk it is suggested that in the event this transpires, officers are authorised to undertake an earlier funding competition, subject to reporting back to Council on the results of such a competition.

6.3 There are potential reputational risks associated with either securitising now or deciding to delay the securitisation. However, the opportunity presented to Council by securitising the Non-Operational Estate has identified securitisation as a means of not only generating savings from spend to save transformational projects, but also from utilising the process to revitalise the non-operational estate and to improve other service areas which may not necessarily generate significant savings, but which are Council priorities.

7. Equalities, Health and Human Rights Impact Assessment (EIA)

7.1 No issues were identified in relation to any potential equality impact from this report. However, a full Equalities, Health and Human Rights Impact Assessment (EIA) will be an integrated element of any of the detailed business cases submitted to Council for approval.

8. Strategic Assessment

8.1 The overall approach being taken to achieve the securitisation of the Council's non-operational property portfolio has the potential to have a significant impact on all of the Council's 4 priorities. The number of projects which involve new build will assist in the social and economic regeneration of the area. The financial model adopted will contribute to the effective deliver of the Council's financial strategy. Asset Management will be improved by the significant investment in buildings, both from a new build and maintenance perspective. Finally all of the proposed projects are capable of improving our current services and ensuring that the Council has fit for purpose services in to the future.

9. Conclusions and Recommendations

9.1 The timing of the proposed funding competition to generate an investment fund of around £35m through securitising the Council's non-operational estate rental income stream is important in terms of the financial effect it will have on the general services revenue account over the next few years.

9.2 Assuming Council wishes to continue with the securitisation project then there are three options available to Council at this stage:

1. Run a funding competition now, as originally planned (though slightly delayed compared to the intention agreed at Council in January 2011) to generate the investment fund by around January 2012;

2. Recognising the likely phasing of the expenditure outlay, run a funding competition now with a provision within the lending agreement that the Council may draw-down the funding as required from the lender in line with the phased expenditure plan; and

3. Recognising the fact that, whatever investment projects are agreed to proceed by Council later in this financial year, the actual outlay of expenditure will be phased over the next 4 financial years, that the funding competition is delayed until April 2012 with a view to accessing the investment funding around October 2012 (see Appendix 1 - Project Timeline).

9.3 As it is not clear at this stage that a full £35m will be required to fund the potential projects that are currently being developed, it would appear to make more sense to await the Council decision in December 2011/January 2012 regarding which (if any) projects should proceed through this funding stream, as it is only at this point that the level of investment funding required will be known. In addition, that as and when a funding competition is commenced that Council should seek an option which allows a draw-down of the securitisation funding created, as this offers the lowest cost route to implementation.

9.4 It is recommended that the Council:

(i) note the good progress made within the Securitisation Project and in particular in the setting up of the Limited Liability Company, preparing the tender documentation and developing the detailed business cases for the investment projects, previously presented to Council in June 2011;

(ii) note the Project Timeline at Appendix 1 and the timescales to meet an October 2012 start date for the Limited Liability Company and the Debt Finance Agreement;

(iii) agrees that a briefing session is organised for late November 2011 to update Members on the detail of the Investment Projects being put to Council in December 2011 for decision;

(iv) agrees that reports on the Detailed Business Cases will be presented for approval to Council from December 2011 and as soon as possible thereafter;

(v) agrees a Members' day be organised to cover all aspects of the governance arrangements relating to; the setting up and running of the Limited Liability Partnership and the implementation and delivery of the investment projects selected for securitisation support;

(vi) agrees that Officers implement Option 3, that the Funding Competition for the Securitisation of the Rental Income stream from the Council's Non-Operational Estate be delayed with a view to obtaining such funding from 1 October 2012;

(vii) agrees that the Funding Competition should seek to identify options for both an immediate draw-down and a phased draw-down facility from potential lenders and should be based on the finance required;

(viii) in the event that prior to October 2012, there is a material rise in interest rates which would increase the overall costs of borrowing, Officers are authorised to undertake an earlier Funding Competition, subject to reporting back to Council on the results of such a competition; and

(ix) agrees that the Financial Strategy is revised to take account of the Financial Implications of the above decisions.

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Date: 12 October 2011

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Appendices: Appendix 1: Project Timeline

Background Papers: Reports: Securitisation presented to Council on 26 January and 29 June 2011.

Wards Affected: All