HM Treasury

The Scotland Act 2012:

summary of responses to the consultation on Scottish Government bond issuance

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1 Introduction

Scotland Act 2012

1.1 The Scotland Act 2012 implemented the work of the Calman Commission, which provided a comprehensive overview of the role of tax devolution to the Scottish Parliament within the overall UK macroeconomic framework.[1] The Scotland Act 2012 preserves the benefits of the fiscal and macroeconomic union between Scotland and the rest of the United Kingdom, while creating a direct link between spending in Scotland and the level of taxes raised in Scotland.

1.2 The Scotland Act 2012 and the measures outlined in the command paper published alongside the introduction of the Bill, deliver the largest single transfer of fiscal power from Westminster in the history of the United Kingdom. Its powers give the Scottish Parliament greater responsibility for the taxes required to fund their spending decisions and will improve the accountability of the Scottish Parliament to the Scottish people. For the first time, spending decisions made in Scotland will have significant consequences for taxation in Scotland, and vice versa. When the Scotland Act 2012 is fully implemented (from April 2016 onwards), the Scottish Parliament will move from raising less than 15 per cent of its own budget to around 30 per cent.

Borrowing

Current spending

1.3 Under the powers enabled by the Scotland Act 2012 and the associated command paper, Scottish Ministers will be able to borrow to finance current spending:

a. within year, to provide the Scottish Consolidated Fund with enough balance to ensure cash-flow when taxes are devolved and to manage excessive in-year volatility of receipts;

b. across years, to smooth any differences between outturn receipts from devolved taxes and their forecast, up to a total of £500 million total current debt; and

c. on an annual basis borrowing will be capped at a level which is sufficient to deal with forecasting errors in normal times: £200 million.

Capital spending

1.4 From April 2015, when Scottish Ministers take control over certain revenue streams, a further dimension of financial accountability will provide for Scottish Ministers to borrow to fund capital projects for the first time. The power will be transferred to Scottish Ministers in phases:

a. from 2011-12, Scottish Ministers are able to make pre-payments to fund early work on the Forth Bridge Replacement Crossing;

b. from 2015-16 Scottish Ministers can borrow up to 10 per cent of the Scottish capital budget in any year to fund additional capital projects; approximately £230 million in 2014-15; and

[1] www.commissiononscottishdevolution.org.uk

c. from 2015-16, the overall stock of capital borrowing cannot exceed the limit set out in the Scotland Act 2012 (at present £2.2 billion, with a power provided to raise this limit, but never lower it below £2.2 billion).

Sources of borrowing

1.5 The Scotland Act 2012 gives Scottish Ministers access to the source of borrowing as recommended by the Calman Commission: loans from the UK Government in the form of access to the National Loans Fund (NLF) via the Secretary of State for Scotland for both capital and current expenditure.

1.6 To allow for greater flexibility in respect of capital expenditure, the Scotland Act 2012 also provides for Scottish Ministers to borrow by way of loans from commercial banks, subject to the condition that the Scottish Government's Accounting Officer is satisfied that this represents good value for money.

2012 consultation on bond issuance

1.7 In order to ensure that the new system of Scottish borrowing is flexible and sustainable, the Government included a provision in the Scotland Act 2012 which enables it to amend, in future, the way in which Scottish Ministers can borrow to include bond issuance, without the need for further primary legislation.

1.8 Borrowing by way of bond issuance involves a wider range of potential costs and risks, including for the rest of the UK, than for the other forms of borrowing already permitted by the Scotland Act 2012. Therefore, in June 2012 the UK Government published a consultation document to gather views and evidence on whether to grant the Scottish Government the power to issue its own bonds for capital investment, in addition to the sources of borrowing already provided for, up to the amount stipulated in the Scotland Act 2012 (£2.2 billion).[2]

1.9 Nineteen responses were received in total, from a broad range of interested parties. A list of respondents is given in Annex A.

1.10 This document summarises the responses received to the consultation.

[2] http://www.hm-treasury.gov.uk/d/condoc_scotlandact2012_bond_issuance.PDF

2 Summary of responses

2.1 In total, there were nineteen responses to the consultation, including from the Scottish Government, a number of potential investors, market participants, representative bodies, academics and organisations associated with other devolved governments. Most respondents felt the relevant issues had been correctly identified in the consultation document; only a handful of respondents highlighted additional issues for consideration. Responses therefore tended to focus on the relative importance of these issues. Overall, of the responses that gave a clear opinion on whether the Scottish Government should be granted the power to issue to its own bonds, six were in favour of the proposal and three were against. Ten did not come to a clear view.

2.2 A number of respondents noted the problems caused by the uncertainty around the future constitutional status of Scotland, even if the prospect of independence is settled in the near term in the 2014 referendum; indeed two respondents felt it was impossible to consider the case for bond issuance at this time.

Evidence gathered on potential benefits

2.3 Respondents highlighted a number of potential benefits that could be achieved by Scotland issuing its own bonds. These included the additional flexibility the Scottish Government would gain over its sources of borrowing, potentially allowing it to access a wider pool of lenders. In theory, this could reduce the cost of borrowing compared to commercial bank lending. It was also felt that bond issuance could provide greater flexibility in relation to the term structure and conditions of borrowing that would be available to the Scottish Government. It was observed that local authorities already have the power to issue bonds.

2.4 Some respondents felt that it would be beneficial for both Scotland and the UK as a whole for the Scottish Government to feel more direct accountability through the market for its borrowing. They felt that might lead to improved policy outcomes, enhanced transparency and more effective long-term planning.

2.5 Others, however, believed that such benefits were unlikely to be significant in practice and could in any case be achieved more effectively through other means (e.g. transparent reporting and accounts).

Evidence gathered on potential costs and risks

2.6 While respondents indicated that demand would likely accommodate £2.2 billion of bond issuance, the majority believed that bonds issued by the Scottish Government would likely translate into a cost of borrowing significantly above that enjoyed by the UK Government. The factors most often cited included the perceived lower creditworthiness of the Scottish Government, owing in particular to its narrower revenue base and lack of a track record in borrowing, as well as the lower liquidity of Scottish Government bonds compared with UK gilts. A number of respondents commented that demand would also inevitably be contingent on the characteristics of the bonds, in particular their credit rating and any guarantee from the UK Government.

2.7 Relatively few respondents attempted to estimate the likely yield premium on Scottish government bonds over gilts. Those that did indicated that the spread over UK gilts would most likely be in the range of 30 to 120 basis points depending on the status of any guarantee and the level of ongoing uncertainty about Scotland's constitutional future. Most respondents used the spreads for other UK sub-sovereign entities (e.g. Network Rail, Transport for London (TFL)) as well as international examples that could be relevant in this case (e.g. Canada and Germany) as a benchmark. In most cases it was felt that the borrowing cost would be above the cost that the Scottish Government would face to borrow directly from the National Loans Fund, (roughly 20 basis point (bps) spread over the rate on an equivalent-maturity UK gilt). Several respondents suggested that this yield premium could fall over time as the Scottish Government established a track record and demonstrated itself to be a creditworthy issuer. However, others felt that the majority of the spread would reflect the likelihood of the Scottish Government's having a lower ongoing credit rating and the significantly lower liquidity of its debt.

2.8 Those respondents most in favour of granting the Scottish Government the power to issue bonds generally argued that, regardless of cost, it should be for Scottish Ministers to decide the most appropriate form of borrowing and to demonstrate its cost-effectiveness.

2.9 Several respondents mentioned the risk of moral hazard if the market was to infer some level of support from the UK Government. Some felt that this was likely even in the absence of a formal government guarantee. Others, however, agreed with the view put forward in the consultation document that such a risk was mitigated to a large extent by the borrowing limits set by the UK Government.

2.10 In terms of the potential risks posed to the rest of the UK, including the risk of fragmentation of the gilt market or fiscal costs imposed on the rest of the UK, most respondents generally agreed with the assessment presented in the consultation document that such risks were possible but were likely to be limited at the levels of issuance currently anticipated. A minority of respondents felt that even at the current borrowing limits a deterioration in the Scottish Government's fiscal position could have a negative effect on the UK's creditworthiness and reputation.

2.11 Many respondents did, however, flag that such risks might be expected to become more material were the Government ever to increase the Scottish Government's borrowing limits and cited international examples of such risks having crystallised.

Next steps

2.12 The Government will make a decision about whether to grant the Scottish Government the power to issue bonds ahead of capital borrowing powers being introduced in 2015-16.

3 Summary of responses to individual questions

Question 1: What does the theory of fiscal decentralisation tell us about the merits and demerits of Scottish bond issuance, including, and beyond, the issues covered in this document?

3.1 This question produced a range of responses. Respondents on the whole felt the theoretical advantages and disadvantages of sub-sovereign bond issuance were well-covered in the consultation document. However, they drew a range of different conclusions on the overall trade-off in the light of the weight they attached to the different considerations.

3.2 Several respondents outlined the case for bond issuance having the potential to increase accountability and exert market discipline on sub-sovereign borrowers within a decentralised fiscal system. Some felt that this could lead to greater transparency, better long-term planning and better policy outcomes as a result.

3.3 Several respondents expressed concern about the issue of moral hazard, in particular the risk that the Scottish Government would take undue risk in its bond issuance programme, given the risk that the market may infer an implicit guarantee from the UK Government. It was judged that any guarantee, implicit or explicit, would represent a subsidy to the Scottish Government from the UK Government. However, some did not consider this to justify denying the Scottish Government the power to issue its own bonds: a properly agreed and well-managed regulatory framework that included subjecting the Scottish Government to fiscal constraints similar to those for the UK was thought by some respondents to be appropriate and sufficient to mitigate this risk.

3.4 A minority of responses focussed on the role of borrowing in smoothing revenue and acting to counter the economic cycle. However, these arguments appeared to be focussed on decentralising borrowing powers in general and not on the specific question of bond issuance as a source of borrowing.

Question 2: What insights do UK precedents for sub-sovereign bond issuance provide for Scotland?

3.5 Almost all respondents who addressed this question noted that a number of public bodies in the UK have raised capital successfully through issuing bonds. Some respondents felt this demonstrated that UK sub-sovereigns can be trusted to use bond issuance powers responsibly. Some respondents also believed that Scotland should be able to issue bonds because Local Authorities already have the power to do so.

3.6 Many respondents noted that sub-sovereign issuers in the UK pay an interest rate premium over UK gilt yields, despite many enjoying either an explicit guarantee from the central government or some level of implied support. Respondents noted that the liquidity of the market and the degree of intrinsic government support was fundamental to the interest rates on the bonds issued by sub-sovereigns. However, one respondent cautioned that the experience of UK Local Authority bond issuance is either too rare or dated to be instructive. Another respondent felt that the lack of recent Local Authority bond issuance showed that bond issuance would always be likely to be more expensive for Scotland than borrowing from the NLF and commercial banks.

3.7 Some respondents noted the strong safeguards in place for other sub-sovereign issuers in the UK to mitigate the risk of moral hazard, for example governing the level of financial indebtedness in the case of Network Rail, and in the case of TfL, the ability for central government intervention if deemed appropriate. It was noted by one respondent that unlike many European countries, the framework for financing the UK sub-sovereigns is highly centralised with the majority of sub-sovereigns borrowing directly from the central government through the Public Works Loan Board (PWLB). They also noted that the prudential borrowing regime, which applies to local government in the UK, allows central government to retain the power to limit capital.

3.8 A minority of respondents felt that few parallels could be drawn given the different nature of other sub-sovereign issuers in the UK.

Question 3: What are the implications of governments providing, or not providing, explicit guarantees for the borrowing of a sub-sovereign?

3.9 Most respondents who addressed this question noted that an explicit central government guarantee improves the creditworthiness of the sub-sovereign borrower and lowers the interest rates on sub-sovereign issuance. The extent to which this applies was thought to be contingent on the strength of any implicit guarantee that would be inferred by the market in any case and the stand-alone creditworthiness of the sub-sovereign. Some respondents noted that guarantees can take a number of forms and fiscal arrangements between a sovereign and its sub-sovereign are subject to scrutiny by investors and rating agencies.

3.10 Several respondents noted that an explicit guarantee would impose an additional contingent liability on the sovereign's fiscal burden. It was suggested by one respondent that this liability could be mitigated (in part) by charging a fee to the sub-sovereign in exchange for the explicit guarantee, while another respondent indicated it might be offset by the benefit to the sovereign from lower sub-sovereign expenditure on debt interest.

3.11 Another key drawback identified was the role of additional moral hazard in undermining the fiscal incentives of the sub-sovereign and potentially reducing its accountability, which would impact negatively on both the sovereign and sub-sovereign.

3.12 Finally, one respondent noted the potential interaction with sub-sovereign borrowing limits imposed by the sovereign, suggesting that such borrowing limits would justify the provision of an explicit guarantee. Another respondent pointed out that an explicit guarantee might run counter to a sub-sovereign's aspirations for greater autonomy, and therefore be considered by the sub-sovereign to be unwelcome.

Question 4: How relevant to Scotland's situation are the interest rate premia that are observed in countries that issue sub-sovereign bonds?

3.13 The overwhelming majority of responses to this question recognised that Scotland would pay an interest rate premium on its debt relative to the UK, consistent with the experience of other sub-sovereign issuers. A number of respondents were reluctant to infer much more about the size of the interest rate premia from the experience of other sub-sovereigns, given the different institutional and historical circumstances. For example, two respondents noted that comparisons with the experience of the US and its sub-sovereign issuers are unsuitable due to the different tax, legal and constitutional frameworks.

3.14 Those respondents that did try to draw firmer inferences from international experience suggested the interest rate premium faced by Scotland would be somewhere between those faced by sub-sovereigns in Germany and Canada (around 40 to 120bps at the time the consultation was published), consistent with their relative autonomy and the size of their revenue bases.

3.15 A number of respondents noted that Scotland has no history in exercising borrowing powers through capital markets, unlike many sub-sovereigns in the countries highlighted in the consultation document. The extent to which this would impact negatively on the creditworthiness of Scotland was considered uncertain, but it was felt it would take some time for Scotland to build up a track record of successful debt issuance.

3.16 Respondents also noted that debt issued by the Scottish Government would be likely to incur a liquidity premium due to its relatively poor liquidity, given the likely scale of issuance.

Question 5: What are the key risks and benefits to Scotland of bond issuance by Scottish Ministers?

3.17 Responses to this question were quite varied. A number of respondents noted that Scottish bond issuance would give the Scottish Government greater flexibility in relation to the timing and allocation of its resources. Some felt that a more diversified range of funding sources should over time improve the cost-effectiveness of financing.

3.18 Many respondents thought bond issuance could potentially enhance the Scottish Government's fiscal discipline, accountability and transparency, as well as encourage prudent long-term fiscal judgements. However, others noted that credibility could be similarly enhanced without bond issuance, citing the Government Expenditure and Revenue Scotland (GERS) as an effective mechanism for transparency and scrutiny of Scotland's accounts.

3.19 Two respondents noted that the benefits of bond issuance may mainly be political: chiefly as a symbol of Scotland's increased autonomy and potentially as a symbolic pre-cursor to independence. One respondent noted, however, that it could also be a source of significant reputational risk for the Scottish Government if the outcome of issuance was poor.

3.20 Some respondents noted that given bond issuance would be likely to be more expensive than other forms of borrowing, the Scottish Government would need to make greater off-setting devolved spending reductions and/or tax increases to compensate, which would be to the detriment of the Scottish economy. One respondent felt the opportunity cost would be fiscally unjustifiable and directly contradict the UK Government's own debt management objective.

3.21 Another respondent also noted that while bond issuance would provide the Scottish Government with access to an alternative source of funding, it would be important that Scotland retained access to existing sources of finance e.g. UK Government. This was felt to be especially important during times of heightened market uncertainty when spreads could widen sharply, particularly given the Scottish bond market would be much less liquid than the UK gilt market.

Question 6: What is the potential source, scale and depth of demand for Scottish bonds?

3.22 A majority of respondents to this question felt that the extent and sources of demand for Scottish bonds would depend on the characteristics of the bonds issued, including their credit rating and any guarantee provided by the UK, and would also be relatively price-sensitive. Most respondents felt that fundamentally the scale of demand would be sufficient to accommodate the anticipated volume of issuance from Scotland. However, some did remark that they did not anticipate significant demand emerging while uncertainty over Scotland's constitutional future prevailed.

3.23 Two respondents suggested potential demand would be mostly confined to a UK investor-base, consistent with the composition of demand for other UK sub-sovereign bonds and

German Länder. A number of other respondents indicated that domestic retail investment might represent an additional source of demand, given potential patriotic demand and the interest to date in UK government, supra-national and corporate bonds listed on the London Stock Exchange's retail bond exchange.

3.24 The main factors that respondents identified as acting as a constraint on demand from wholesale investors included:

- a lower perception of creditworthiness relative to the UK;
- poor secondary market liquidity;
- ongoing uncertainty about independence after the referendum in 2014; and
- it being unclear that such bonds would be eligible for inclusion in bond indices.

Question 7: What would be the size of any yield premium investors would require to invest in Scottish bonds (as a spread to the yield on UK gilts)?

3.25 Relatively few respondents attempted to provide a quantitative estimate of the likely yield premium on Scottish bonds over gilts. Those respondents that did provide an estimate indicated that the spread would likely be in the range of 30 to 120bps, though one respondent suggested it could be as large as 200bps due to the uncertainty about Scotland's constitutional future. A number of respondents explicitly said it was unlikely the spread would be below the 20bps that the Scottish Government would incur from borrowing directly from the UK Government via the National Loans Fund (NLF).

3.26 Respondents reiterated that the yield on Scottish bonds would be contingent on a number of factors, some of which are inevitably very uncertain. For example an explicit guarantee from the UK Government could result in a spread to gilts towards the lower end of the range, while the absence of an explicit guarantee would be expected to result in a spread towards the top of the range with it being possible that the market would still imply a significant level of support from the central government.

3.27 A number of respondents believed that any yield premium over gilts might be expected to decline over time if Scotland demonstrated fiscal discipline and thus established a reputation as a creditworthy issuer. One respondent highlighted the risk that spreads could widen significantly at times of market stress. On the other hand, one respondent suggested that over the long-term Scotland could pay a lower interest rate than the UK to borrow (i.e. a negative yield premium) were they to be in a position to issue bonds backed by North Sea oil revenues.

3.28 Several respondents suggested that although bond issuance was unlikely to be cheaper than borrowing from the NLF, it should be for Scottish Ministers to decide the most appropriate form of borrowing and to demonstrate its cost-effectiveness.

Question 8: How significant are the potential benefits and risks of bond issuance by Scottish Ministers to the rest of the UK, including to the gilt market?

3.29 The majority of respondents that answered this question agreed with the potential benefits and costs to the rest of the UK as outlined in the consultation document.

3.30 Most respondents felt the benefits to the rest of the UK would be negligible. However, a few respondents noted that bond issuance in Scotland could improve transparency and direct accountability in the market and therefore reinforce the UK's fiscal control.

3.31 Many respondents agreed with the theoretical risks to the rest of the UK that were outlined in the consultation document. Nearly all respondents agreed, however, that the proposed statutory limits on debt issuance would largely mitigate these risks. Given the depth and liquidity of the UK bond market, a number of respondents also noted that Scottish bond issuance would be unlikely to cause a direct material fragmentation of the UK public debt market. Similarly, most respondents noted that bonds issued by the Scottish Government under the Scotland Act framework would attract a different investor community to that investing in gilts and therefore not significantly detract from demand for gilts. One respondent did, however, suggest there was a risk that the UK's cost of borrowing would rise.

3.32 Moreover, it was felt that the borrowing limits outlined by the Scotland Act would limit the risk of a deterioration in the Scottish Government's finances and changes to the market's perception of its creditworthiness from spilling over and contaminating the perception of the UK as a whole.

3.33 A number of respondents remarked that a number of these risks would become more significant if the borrowing limits were increased in the future.

Question 9: Are there any other issues and risks that could impact on the rest of the UK in giving Scottish Ministers the power to issue bonds? If so, how might any such risks be managed?

3.34 The broad nature of this question attracted a diverse range of responses. A varied range of respondents felt the issue of Scottish bond issuance would need to be considered alongside the debate on independence, despite the consultation paper specifying that the scope of the consultation was Scottish bond issuance within the context of the UK. Two respondents felt that it was impossible to consider the case for bond issuance at this time given the constitutional uncertainty. Another respondent felt investors might look for the inclusion of a "change of status" language in any bond prospectus so that markets could be certain of the constitutional arrangement throughout the life of the issue.

3.35 A few respondents reiterated their view that the risks to the wider UK would be negligible as long as the scale of borrowing is constrained. It was noted that increasing Scotland's borrowing limits would need to be considered very carefully, in light of the likely increase in the scale of the risks to the UK. One respondent for example noted that it is entirely proper for the national government to place reasonable constraints on borrowing.

3.36 Some respondents also suggested that any precedent set for Scotland would need to be considered in the context of subsequent demands from Wales and Northern Ireland for a similar power.

A List of respondents

Association of British Insurers

Baillie Gifford & Co.

Barclays

British Property Federation/Scottish Property Federation

CIPFA Scotland

City of London Law Society

Civil Engineering Contractors Association

Confederation of British Industry

Goldman Sachs

HSBC

Ignis Asset Management

Investment Management Association

The Finance Committee of the National Assembly of Wales

The Scottish Government

UNISON Scotland

Professor Andrew Hughes Hallett, University of St Andrews

W P Mennie BL NP IAC MCSI

Professor Robert Rowthorn, University of Cambridge

Professor Francois Vaillancourt, University of Montreal

B Glossary of key financial market terms

Table B.1: Glossary of key financial market terms

Basis point	One hundredth of one percent (i.e. 0.01 per cent).
Bond	A debt security in which the authorised issuer owes the holder a debt and, depending on the terms of the bond, is obliged to pay interest (the coupon) at regular intervals (e.g. semi-annual) and/or to repay the principal at a later date, termed maturity.
Credit rating	A measure of the creditworthiness of an issuer (e.g. corporation or government) of specific types of debt produced and assigned by credit rating agencies.
Gilt	A bond issued by the UK government.
Liquidity	The ease with which investors can transact in their desired quantity and at their desired time in a particular market or instrument.
Maturity	The amount of time before the investor's principal (the upfront investment) is repaid.
Premium	An additional debt interest cost reflecting the market's pricing of the yield (see below) on a bond.
Spread	The difference in the yield (see below) on two bonds reflecting the market's different pricing of each bond according to divergence in factors such as credit risk and the expected future path of interest rates (e.g. the difference between yields on UK government bonds and German government bonds).
Yield	The income return on an investment, usually expressed annually as a percentage of the value of the initial investment.

Source: HM Treasury

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This document can be downloaded from www.gov.uk

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