Agenda Item No:4

MUNICIPAL BONDS AGENCY UPDATE

To:	**General Purposes Committee**		
Meeting Date:	**2nd February 2016**		
From:	**Chief Finance Officer**		
Electoral division(s):	**All**		
Forward Plan ref:	**2016/019**	*Key decision:*	**Yes**
Purpose:	**To bring an update on the Municipal Bonds Agency and seek authority to enter into the Framework Agreement and Guarantees.**		

Recommendation: **That General Purposes Committee:**

1. Recommend to Council that they note:

a) The risks of entry into the Framework Agreement and Guarantee, and undertaking borrowing from the UK Municipal Bonds Agency; and

b) The Counsel opinion of Jonathan Swift QC

2. Recommend to Council that they approve entry into the Framework Agreement and accompanying Schedules (Document 3 of the Documents Package within confidential Appendix A: Documents Package) listed:

c) Schedule 1: Form of Authority Accession Deed
d) Schedule 2: Form of Guarantee
e) Schedule 3: Loan Standard Terms
f) Schedule 4: Form of Loan Confirmation

3. Subject to the above, delegate authority to the Council's Section 151 Officer and Monitoring Officer to execute all the necessary contractual arrangements, including the Framework Agreement, Guarantee and Schedules listed in recommendation number 2.

	Officer contact:
Name:	Mike Batty
Post:	Group Accountant – Treasury & Investments
Email:	mike.batty@cambridgeshire.gov.uk
Tel:	01223 699942

1. INTRODUCTION

1.1 The UK Municipal Bonds Agency (MBA) was established by the Local Government Association (LGA) and 56 local authorities, including Cambridgeshire County Council, for the purpose of enabling local authorities to borrow on better rates of interest than would otherwise be available to the local authority and to provide an alternative to the Public Works Loan Board (PWLB).

1.2 The Council became a shareholder in the MBA during 2014-15, following approval at a Council meeting on 22nd July 2014 to invest £400k equity. In total over £6m has been raised from the 56 local authorities plus the LGA.

1.3 Given the Council's significant borrowing requirement of approximately £160m to finance the capital programme over the medium term, it was considered in the Council's interest that the MBA was established so as to reduce financing costs in the years ahead.

1.4 In order to be able to borrow from the MBA a local authority must accept the terms of the Framework Agreement and grant joint and several guarantee. This means that a local authority will be guaranteeing all the existing finance obligations of the MBA and any future obligations which are entered into.

1.5 Over the past six months a small group of local authorities, acting as informal working group on behalf of English local authorities and advised by law firm Allen & Overy, have been working on the Framework Agreement and Schedules provided by the MBA and their legal advisors Clifford Chance. Counsel opinion was also sought by the working group and Allen & Overy as to whether local authorities could lawfully enter into the Framework Agreement and Guarantee and borrow from the Agency.

1.6 Background information is included in confidential **Appendix A**: Documents Package for Local Authorities (Documents Package) which includes the Framework Agreement and other supporting documentation. The Document Package reflects a robust challenge process and comprehensive level of due diligence and as such Council is asked to approve the recommendations above.

1.7 This report describes the risks of entering into the Framework Agreement and providing the Guarantee, and the safeguards and protections that are in place to mitigate the Guarantee from being exercised. It also sets out the legal powers relied upon to enter into these contracts.

2. UK MUNICIPAL BONDS AGENCY – OVERVIEW OF THE MBA

<u>Background to MBA</u>

2.1 The Local Government Association (LGA) established the UK MBA in June 2014 with the primary objective of reducing UK local authority financing costs, through becoming the most efficient and cost effective provider of finance.

2.2 The MBA will borrow money from a variety of third parties, including local authorities, and on-lend, on a matched funding basis to UK local authorities.

2.3 In March 2014 a revised Business Case was published by the LGA containing details as to how a municipal bonds agency would expect to issue bonds on behalf of local authorities in an efficient and cost effective manner and at lower rates than from existing facilities such as the Public Works Loan Board (PWLB).

2.4 In order to achieve the most competitive pricing and beat PWLB rates, the MBA will have to be viewed as a strong counterparty and have a strong credit rating, achieved through (amongst others), the following mechanisms:

- A joint and several guarantee granted by each of the borrowing local authorities covering the full amounts owed by the MBA under any financing document which is covered by the guarantee;
- Contribution arrangements, whereby if a local authority defaults on one of it payments to the MBA, the MBA shall require each other local authority that is party to the Framework Agreement to put in funds to cover the shortfall; and
- A very conservative risk profile.

2.5 In giving the joint and several guarantees, local authorities will be relying on the MBA to ensure appropriate standards of credit worthiness in relation to each of the local authorities and liquidity management.

<u>MBA's Client Base</u>

2.6 The MBA will only lend to UK local authorities who can give a joint and several guarantee. This client base is currently limited to 353 principal English local authorities, which have the general power of competence pursuant to section 1(1) of the Localism Act 2011 (the "General Power of Competence") including the power to give a joint and several guarantee, and which satisfy the terms of the Framework Agreement in relation to accession of local authorities.

2.7 The ability to give joint and several guarantees may in due course be extended to other local authorities, e.g. combined authorities or Scottish or Welsh authorities. In the event that this occurs, they will be eligible to borrow from the MBA, subject to appropriate credit checks.

2.8 The MBA would, in due course, like all local authority borrowers to become shareholders in the MBA. This ensures a stronger alignment of interest between local authority borrowers and shareholders and is viewed positively by ratings agencies and the markets. Accordingly, the MBA will charge a higher interest rate to local authority borrowers who are not shareholders, albeit one which remains competitive.

<u>Borrowing from the MBA</u>

2.9 In order to borrow from the MBA, a local authority will need to enter in to the Framework Agreement with the MBA.

2.10 The Framework Agreement detail how the MBA expects to interact with local authority borrowers, including detailing how the joint and several guarantee and contribution arrangements will work and documenting the loan standard terms and condition.

Expected MBA Lending Timeline

2.11 The lead up to the initial bond issue will require a degree of coordination as local authorities who wish to borrow from the MBA go through these approval processes and the volume of demand for financing builds. The Council is looking to participate in the first bond issuance to raise a small amount of borrowing.

2.12 Once a local authority has signed the required documentation, the MBA will carry out its credit assessments prior to entering into any loan with a local authority. Once the MBA has sufficient borrowing demand built up the process of issuing a bond will commence.

2.13 It is expected the majority of local authorities who wish to borrow from the MBA in the early stages will have received appropriate internal approvals by the end of March 2016, hence the reason for seeking approvals in this report.

2.14 The MBA has completed all the necessary internal steps to be able to issue a bond fund borrowing requirements at short notice. Nevertheless, the MBA will only issue a bond when market conditions are appropriate, and accordingly will look for flexibility within a 2 to 4 week window, once local authorities have committed to borrow.

Pricing of the MBA's loans

2.15 The MBA operated a transparent pricing structure. The MBA will charge a margin over its underlying borrowing costs to borrowing local authorities. This margin is currently set at:

- 10 basis points (0.10%) for shareholders; and
- 15 basis point (0.15%) for non-shareholders.

2.16 The MBA may adjust these margins for new borrowing transactions at its discretion, but will not increase them. It is expected that over time these margins will reduce.

2.17 In addition the MBA will pass on any transaction costs to local authority borrowers. These costs will include: rating agency fees, bank syndicate fees and legal costs. These will not exceed 50 basis points (0.50%) on the total amount borrowed.

Prepayment

2.18 Any loans from the MBA will be funded by money borrowed by the MBA from the markets, institutions or local authorities. Prepayment rights will track through between the local authority loans and the MBA financing arrangements. For bond issues, voluntary prepayment is calculated in a similar way as PWLB premature repayment.

Approach to credit assessment of local authorities

2.19 Prior to approving any loans, the MBA will carry out a credit review on the local authority.

2.20 The MBA has developed proprietary credit scoring models based on similar methodologies to the main ratings agencies. In order to access funding from the MBA, a local authority would need to be able to achieve a single A credit rating on a stand alone basis (rating agencies would typically "notch up" a local authority to account for implied Government support").

2.21 In addition to credit scoring, the MBA will ensure appropriate diversification of its lending portfolio, through the contractual concentration limits agreed in the Framework Agreement.

<u>Key elements of the Framework Agreement</u>

2.22 The Framework Agreement is primarily designed to mitigate the risk of a call on the joint and several guarantee, and lays out contractually how the MBA will interact with local authorities.

2.23 The joint and several guarantee will be provided by local authority borrowers, in favour of the underlying providers of finance. The guarantee is required to be unconditional and irrevocable. Accordingly, from the point in time at which the guarantee is executed, a local authority is guaranteeing all the financing obligations of the MBA. Should a local authority give notice to withdraw from the guarantee, including repaying all outstanding borrowings, it will continue to guarantee the borrowing or the MBA which are outstanding at that point in time.

2.24 The Framework Agreement mitigates the risk of a call on the joint and several guarantee. It does this in a number of ways:

- It required the MBA to carry out certain processes, e.g. credit check, and not to lend money to local authorities which it believes do not pass the credit assessment;
- It required a level of diversification, which ensures that the MBA does not become overly concentrated in lending to a particular authority;
- It sets out the timelines for payment to ensure that the MBA has funds in place on a timely basis for payments of interest and principal;
- It includes requirement for notification in the event that an authority will have difficulty in meeting its payment obligations.

2.25 In addition the MBA will maintain standby liquidity facilities, which are intended to be sized at an amount sufficient to avoid default on an interest payment.

2.26 In the event that an authority does not meet its obligation to the MBA on a timely basis, the MBA is required to ask authorities to make contribution (contribution arrangements) to meet the shortfall in proportion to their borrowings, in the form of a contribution loan, to avoid the guarantee being called in.

2.27 In the event that a contribution is made, the MBA is required to pursue recovery of the debt, from the defaulting authority, on a timely basis.

<u>Default by a local authority</u>

2.28 No principal local authority has default on any loan (from the PWLB, a bank or any other lending institution).

2.29 The statutory and prudential framework under which local authorities operate is amongst the strongest in the world.

2.30 Any lender to a local authority has protection, under statute, by way of a first charge on the revenue of that authority.

2.31 In addition, the reputational damage which would be suffered by a defaulting local authority would be significant.

MBA Credit Rating

2.32 The MBA has a private credit rating, which it will make public at the appropriate time. The range of local authority borrowers/guarantors may impact the credit rating.

Governance of the MBA

2.33 The MBA is a public limited company and as such is directed by its Board. In due course, it is expected that the Board will include 7 non-executive and 3 executives.

2.34 In addition, the Board will have the following 2 sub-committees, chaired by independent non-executives:

- Risk, Compliance and Audit Committee; and
- Nomination and Remuneration Committee.

3. COUNSEL OPINION

3.1 Jonathan Swift QC was asked to provide an opinion as to whether (amongst other things):

- Entry into the Framework agreement, execution of the Guarantee, entry into borrowing transactions under the Framework Agreement and the provision of contribution loans would all be within the general power of competence under the Localism Act; and
- A local authority that decides to enter into the Framework Agreement and the Guarantee on the basis of the Document Package (see confidential Appendix A: Documents Package) would be acting in accordance with the requirement of *Wednesbury* reasonableness.

3.2 His main conclusions are that:

- Local authorities do have the power, in principle, to enter into the arrangement envisaged by the Framework Agreement; and
- Whilst it would, in principle, be lawful for a reasonably financially robust local authority to enter into the commitments entailed in the Framework Agreement, the final assessment of whether or not it would be reasonable use of the in principle power must be made taking into account the specific

financial position of each local authority.

3.3 Jonathan Swift QC's opinion was procured independently of the MBA for the benefit of the Councils as an informal working group on behalf of local authorities as a whole.

4. RISKS AND SAFEGUARDS OF ENTRY INTO FRAMEWORK AGREEMENT

4.1 Given the participating local authority's exposure to the contribution arrangements and/or the Guarantee when borrowing from the MBA, it is important to understand that entry in to the Framework Agreement and borrowing form the MBA is therefore very different in nature to borrowing from the Public Works Loan Board, under a bilateral loan facility or through a bond issue in the capital markets.

4.2 There are inherent risks associated with the proposed structure for any local authority entering into the Framework Agreement, not least the joint and several nature of the Guarantees that participating local authorities are required to provide before borrowing from the MBA. These are:

- The risk to a participating local authority is that its Guarantee may be called independently of any other Guarantee and for the full amount owing by the MBA under the financing document which is covered by such Guarantee (and, therefore, such participating local authority is potentially liable to pay out amounts to the MBA that vastly exceed the amounts borrowed).

- Participating local authorities should also note that, even after a participating local authority has terminated its Guarantee, it will continue to guarantee the "Guaranteed Liabilities" entered into by the MBA before the date of termination of the Guarantee. The effect of this is that a participating local authority's liability under its Guarantee may potentially continue in existence for many years after termination.

4.3 However, the risks associated with the Guarantees are mitigated by the contribution arrangements mechanism. The Framework Agreement is therefore designed such that the real exposure for participating local authorities, from a practical perspective, should be under the contribution arrangements rather than the Guarantees, and the exposure of each participating local authority would be calculated by reference to the amount borrowed by it as a proportion of all non defaulting participating local authorities borrowing under the structure.

4.4 Even though the participating local authorities are entitled to expect that the MBA will operate in accordance with its obligations under the Framework Agreement, participating local authorities are nevertheless inevitably exposed to the risk that the MBA fails to observe its obligation under the Framework Agreement. This may include failure to sustain and police robust due diligence and credit assessments on acceding local authorities (therefore making it more likely that the participating local authority will need to contribute over and above their borrowings whether through the contribution arrangement or the Guarantee). It is also possible that the MBA itself may default on its underlying bilateral borrowing from counterparties or under bond issues by not managing its cash flows in a prudent manner or that the MBA may fail to operate the contribution arrangements in a manner as envisaged in the Framework Agreement, in which case, each participating local authority is exposed to a call on it guarantee without the protection that the contribution arrangements provide.

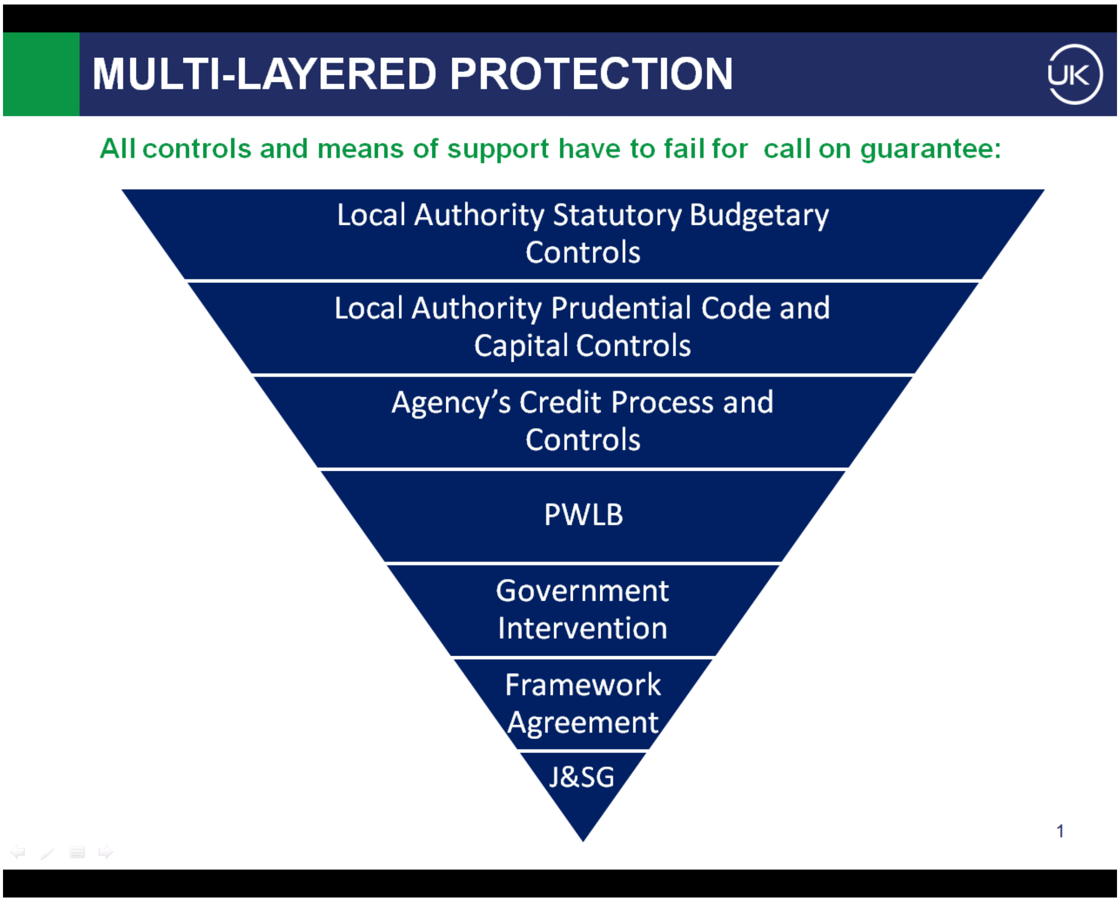
4.5 However, the Framework Agreement does contain provision to mitigate the risks identified above, in summary by:

- The contractual obligations upon the MBA to undertake credit assessments of each LA;
- The limit on the amount each participating local authority may borrow from time to time
- The matched transactions basis on which the MBA itself will borrow money
- The power for participating local authorities to collectively instruct MBA not to undertake further borrowing.

4.6 In addition to the above, the statutory and prudential framework under which local authorities operate (set out in summary below), should provide some reassurance to the financial standing of the local government sector:

- Compliance with the prudential framework established by Part 1 of the Local Government Act 2003 and related regulations, including the Prudential Code for Capital Finance in Local Authorities published by CIPFA
- Requirement to set a balanced budget in accordance with Section 31A and Section 42A of the Local Government Finance Act 1992
- The Chief Finance Officer's report on robustness of budget estimates and adequacy of reserves under section 25 of the Local Government Act 2003.
- Requirement to publish audited accounts by a statutory deadline
- External audit opinion in respect of a local authority's accounts.

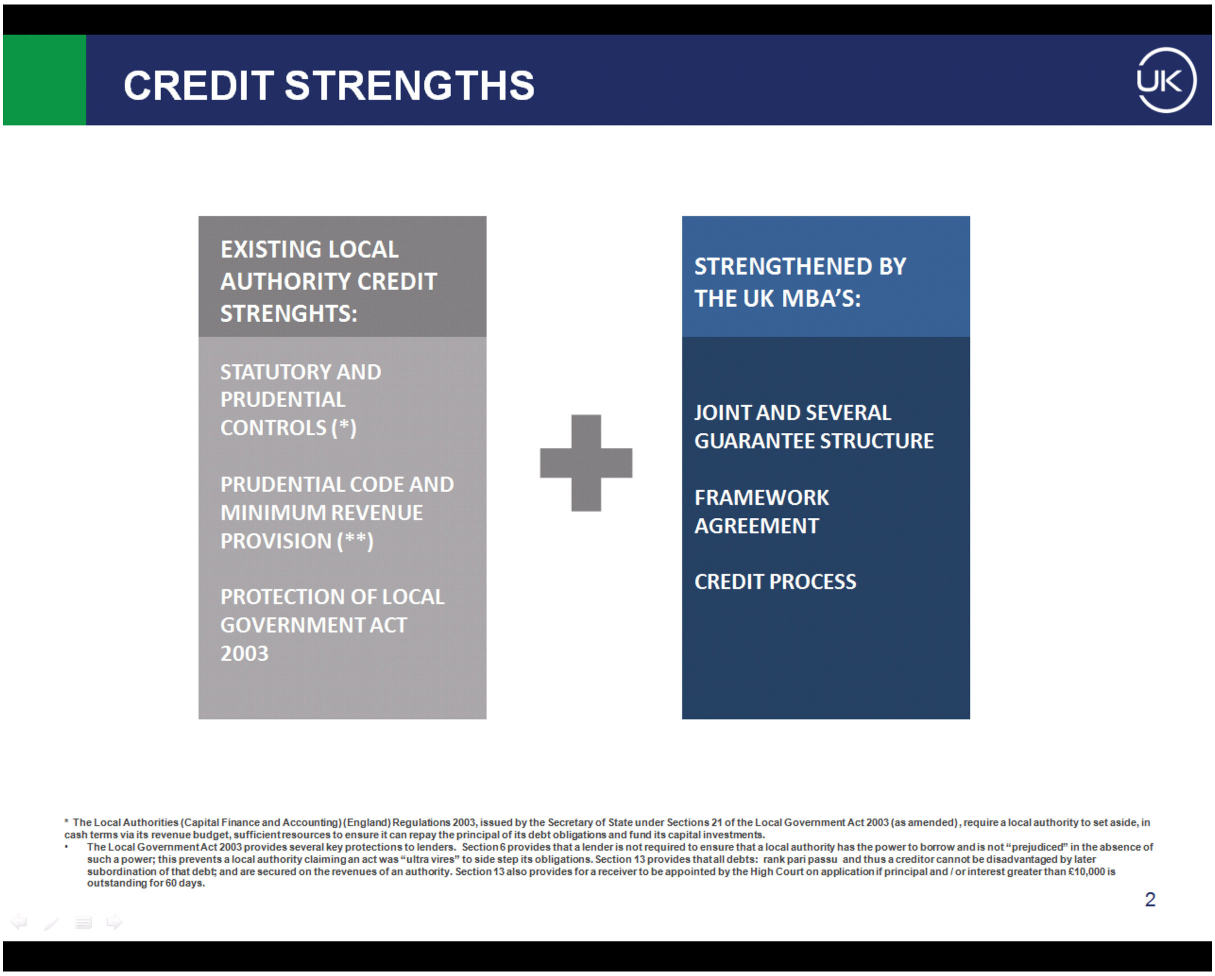
4.7 The slides and diagrams below (provided by the MBA) describe the layers of controls and safeguards in place that have to fail before the call on the guarantee is exercised.



4.8 The local authorities (Capital Finance and Accounting) (England) Regulations 2003, issued by the Secretary of State under Sections 21 of the Local Government Act 2003 (as amended), require a local authority to set aside, in cash terms via its revenue budget, sufficient resources to ensure it can repay the principal of its debt obligations and fund its capital investments.

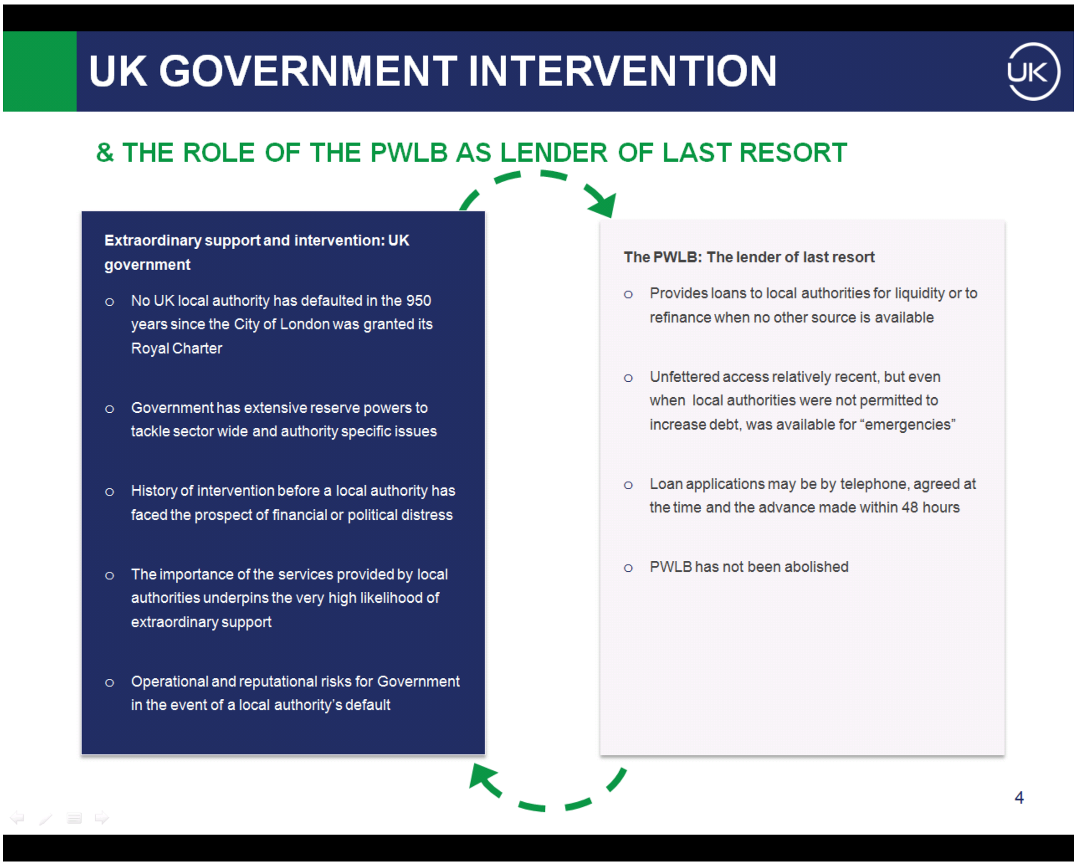
The Local Government Act 2003 provides several key protections to lenders. Section 6 provides that a lender is not required to ensure that a local authority has the power to borrow and is not "prejudiced" in the absence of such a power; this prevents a local authority claiming an act was "ultra vires" to side step its obligations. Section 13 provides that all debts: rank pari passu and thus a creditor cannot be disadvantaged by later subordination of that debt; and are secured on the revenues of an authority. Section 13 also provides for a receiver to be appointed by the High Court on application if principal and / or interest greater than £10,000 is outstanding for 60 days.

4.9 The slide below describes that the existing local authority credit strengths are strengthened by the MBA's Framework Agreement, Guarantee and Credit Process.



4.10 This slide describes the strong legislative framework that local authorities operate within which should provide some reassurances to institutions providing loans to local authorities, through the MBA, as well as local authorities signing providing guarantee.

4.11 The PWLB remains the lender of last resort and may be used by local authorities for liquidity purposes or to refinance loans at short notice.



5. ALIGNMENT WITH PRIORITIES AND WAYS OF WORKING

5.1 Developing the local economy for the benefit of all

There are no significant implications for this priority.

5.2 Helping people live healthy and independent lives

There are no significant implications for this priority.

5.3 Supporting and protecting vulnerable people

There are no significant implications for this priority.

6. SIGNIFICANT IMPLICATIONS

6.1 Resource Implications

There are no significant implications for this priority.

6.2 Statutory, Risk and Legal Implications

The Statutory, Risk and Legal Implication are set out in detail within the main body of the report. The Council has, under the general power of competence pursuant to section 1(1) of the Localism Act 2011 (the "General Power of Competence"), together with the broadly-framed power to borrow at section 1 of the 2003 Act, the power to give a joint and several guarantee and enter into the Framework Agreement. See Document 5 within confidential Appendix A: Documents Package.

6.3 **Equality and Diversity Implications**

There are no significant implications for any of the prompt questions within this prompt category.

6.4 **Engagement and Consultation Implications**

There are no significant implications for any of the prompt questions within this prompt category.

6.5 **Localism and Local Member Involvement**

There are no significant implications for any of the prompt questions within this prompt category

6.6 **Public Health Implications**

There are no significant implications for any of the prompt questions within this prompt category.

Source Documents	**Location**
Confidential Appendix A: Documents Package for Local Authorities	OCT1114 Shire Hall Cambridge