Agenda Item No: 17

UK MUNICIPAL BONDS AGENCY

To:	**General Purposes Committee**
Meeting Date:	**1st July 2014**
From:	**Chief Finance Officer**
Electoral division(s):	**All**
Forward Plan ref:	**N/A** *Key decision:* **No**
Purpose:	**To provide a report for discussion on the Local Government Association (LGA) UK Municipal Bond Agency and investment proposition.**
Recommendation:	**The Committee is recommended:**

i) to note the report; and

ii) to agree whether it wishes to continue supporting the establishment of the Agency at this point, and if so to what level of funding commitment.

Subject to ii)

iii) propose the investment to Council for approval

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1. BACKGROUND

1.1 Local Authority bonds started to come back into the spotlight in October 2010, when the Chancellor unexpectedly announced in the spending review, that PWLB (Public Works Loan Board) rates would increase to 1% above gilts from 0.15%, which significantly increased the cost of borrowing to Councils overnight.

1.2 The rate later came down in November 2012, but in total there have now been six changes to borrowing terms over the last three years. Long term capital programmes require a fair degree certainty for effective decision making, but it could be argued with changes such as these, the PWLB is failing to provide this. As a consequence there is a desire in some quarters to look at bonds as a viable alternative funding vehicle.

1.3 In January 2012 the Local Government Association (LGA) published an Outline Business Case for developing an agency for the issuance of Local Authority bonds. In March 2014 a revised Business Case was published.

1.4 The rationale of such an Agency is about providing a mechanism to secure borrowing from an alternative source to the PWLB, which provides for increase certainty of terms, is free of central government control and with potentially lower rates than available from other sources.

1.5 The LGA is now looking to raise equity funding in the form of share capital from Local Authorities to launch the Agency later this year. This report explains the investment proposition and advantages and risks associated with it against the backdrop of the Council's current borrowing and future borrowing projections.

2. CURRENT SOURCES OF LONG TERM BORROWING

2.1 Long term borrowing is currently taken from two main sources:

- Public Works Loans Board (PWLB)
  - The PWLB is a statutory body operating within the UK Debt Management Office (DMO), an executive agency of H M Treasury. The PWLB's function is to lend money from the National Loans Fund to Local Authorities and other prescribed bodies.
  - PWLB introduced the Certainty Rate in November 2012 which provides a discount of 0.2% to the published rates, provided councils disclose greater information and clarity on their capital funding. Cambridgeshire County Council (CCC) has been successful in qualifying for these favourable interest rates on any new loans raised.

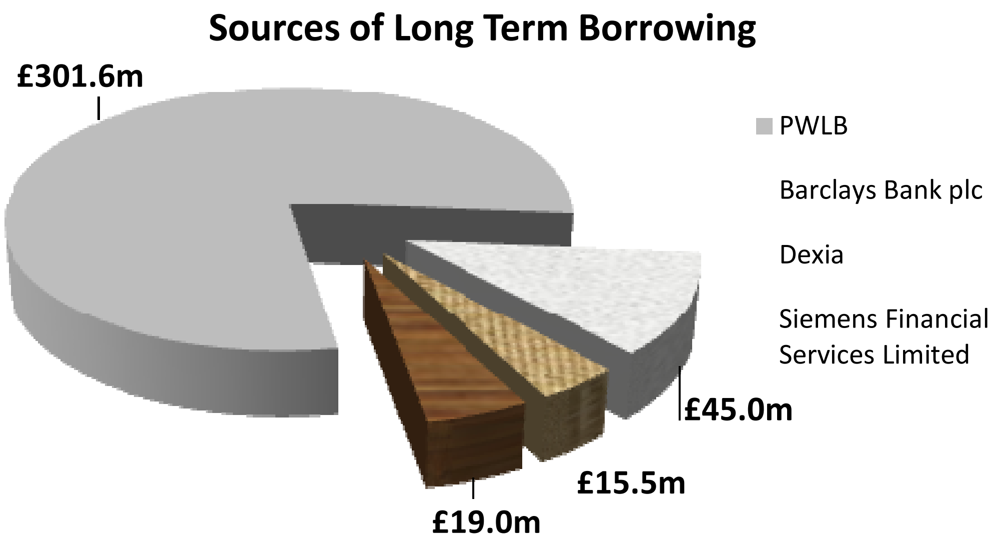
- Money Markets
  - Money market loans are arranged through approved brokers with international banking institutions and other Local Authorities.

2.2 Borrowing via these routes can be secured at short notice and are governed by the Council's Treasury Management Strategy Statement (TMSS) and authorised borrowing limits included within it. However the Government still retains control over overall lending policy and the rates for borrowing from the PWLB.

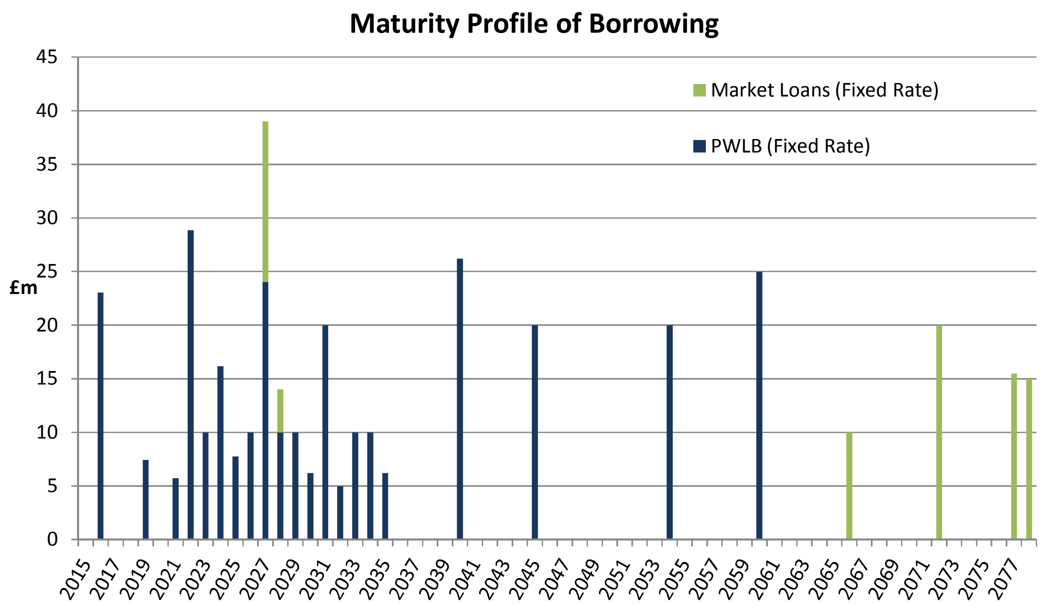
3. CURRENT BORROWING AND PROJECTIONS

3.1 The Council can take out loans in order to fund spending for its Capital Programme. The amount of new borrowing taken each year is determined by capital expenditure plans and projections of the Capital Financing Requirement, forecast reserves, and current and projected economic conditions.

3.2 The chart below shows the current allocation of borrowing by counterparty. The majority of Council's debt is with the PWLB and the remainder is Market borrowing in Lender Option, Borrower's Option(LOBO) instruments. The average interest rate payable on all borrowings is 4.2%.



3.3 The chart below shows the maturity profile of borrowing, split between PWLB and Market Loans, with £91.3m maturing in the next 10 years. All of this debt is likely to be refinanced.



3.4 The projected borrowing requirement and associated budgeted financing costs over the life of the Council's Business Plan are shown in the table below. This information can be found in the Treasury Management Strategy Statement 2014-15 approved by Council in February this year.

	2014-15	2015-16	2016-17	2017-18	2018-19	Total
	£m	£m	£m	£m	£m	**£m**
New borrowing	53	61	4	3	-8	**113**
Refinancing existing	-	23	-	-	7	**30**
Total	**53**	**84**	**4**	**3**	**-1**	**144**
Total borrowing £m	**439.8**	**500.8**	**505.2**	**508.5**	**500.4**	**-**
Interest Budgeted £m	**17.2**	**19.9**	**21.5**	**21.7**	**21.6**	**-**

3.5 Future borrowing is assumed to be taken from the PWLB for modelling purposes, however all borrowing opportunities are considered when loans are actually raised.

4. LGA UK MUNICIPAL BOND AGENCY

Introduction

4.1 Councils source 75% of their borrowing from the PWLB and are therefore vulnerable to the interest rates set by the Debt Management Office (DMO). The Agency would introduce competition and diversity to the market place. The Agency may also offer lower penalties for early repayment of loans, allowing for greater flexibility.

4.2 Local Authorities who raise borrowing through the Agency will need to meet the credit criteria set by the Agency. Experience in other countries has shown that an Agency's credit processes, with the incentive of lower borrowing costs and the oversight of peers, has strengthened the overall credit worthiness of Local Authorities as a whole.

Summary of revised business case

4.3 It is assumed that, to be an attractive proposition, Local Authorities should have a reasonable expectation that they could reduce their borrowing costs by 0.2% - 0.25% versus the PWLB. On a £10m loan this would equate to £20k-£25k per annum.

4.4 The ability for the Agency to achieve such rates is based on the premise that the Agency would achieve a AAA/sovereign like rating. The LGA believe that this could be achievable by holding risk capital between 3% and 5%, holding adequate liquidity, ensuring a diverse portfolio of borrowers, and most importantly providing a joint and several guarantee from borrowers.

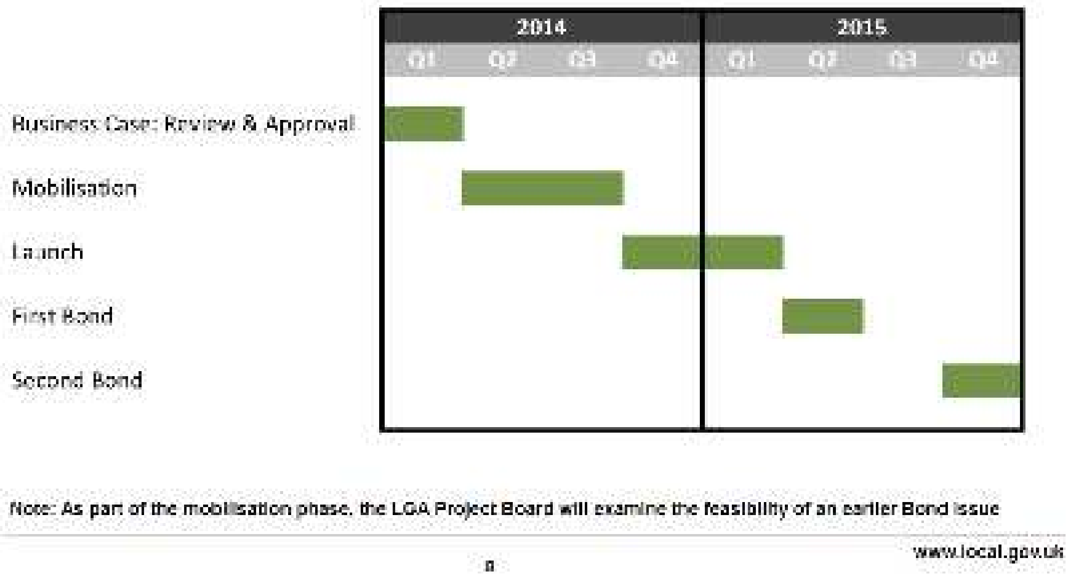
4.5 As well as being crucial to achieving the lower borrowing rates, joint and several guarantees would enable bonds to be listed on the London Stock Exchange. The concept is that borrowers would guarantee their own borrowing and participate in a collective guarantee of other borrowers' obligations. The aim of this would be to significantly improve investors' perceptions of the quality of the Agency's bonds and thus drive down the interest rate.

4.6 The business case explains the protections in place for guarantors which include:

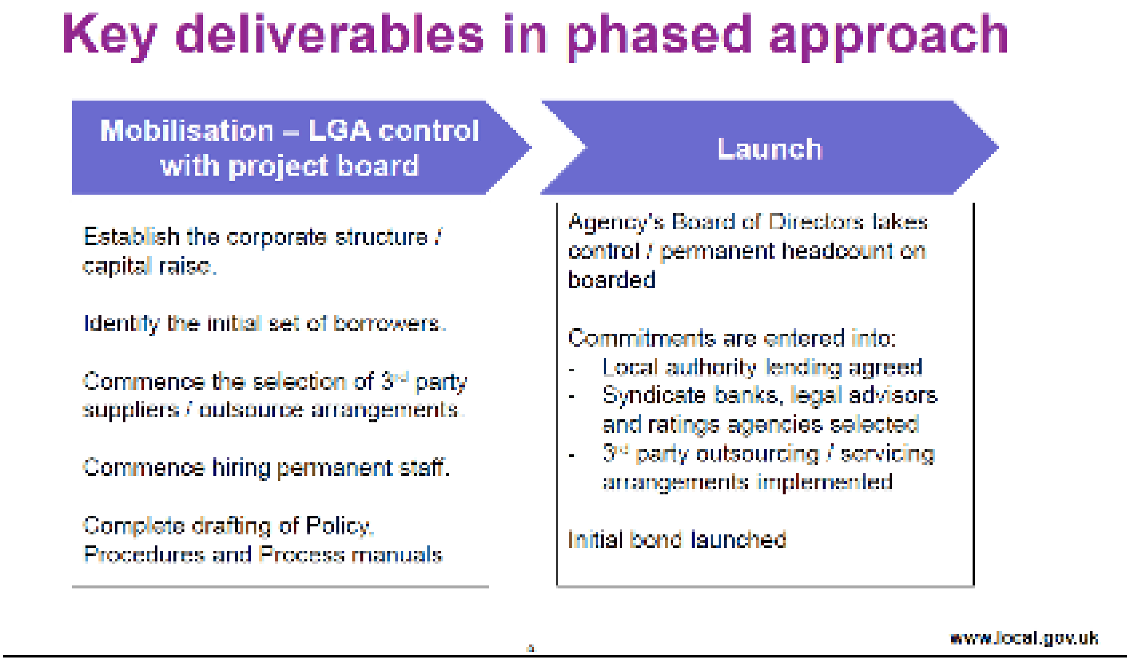
- Significant protections within the statutory framework which governs Local Authority Finances e.g. the Prudential Code. Other protections include; risk capital held and credit processes undertaken by the Agency, Statutory Responsibilities of the Section 151 Officer, access to PWLB, and Government Reserve Powers.
- English law contains a number of protections such as right of indemnity that help ensure that guarantors can recover repayments they make under the guarantee.
- Proportionality / Right of Recourse or equivalent which ensures that in the event of any loss the amount in default is distributed proportionately amongst those providing the guarantee.
- In the event a guarantee is called upon the creditors will still have access to the High Court process which enables the appointed administrator to take control of certain aspects of a Local Authority's finances.

4.7 Because the Agency is new to the market it is likely to need to pay a new issue premium in the first one or two years. This will affect the interest rate payable on the bond for early borrowers. The saving compared to PWLB rates, identified in the business case, will also depend on being able to issue a bond of a suitable size of between £250m and £300m, otherwise investors will demand a premium for liquidity.

4.8 The proposed timetable to issue the first LGA Agency bond in March/April 2015 is shown below.



4.9 There are two phases prior to the issuance of the first bond. A Mobilisation phase, which will cost approximately £0.8m and the Launch phase during which the remainder of the estimated £8m-£10m operating capital will be raised from Local Authorities.



4.10 Control of the Agency will rest with the LGA as the project sponsors during the mobilisation phase. A project Board consisting of LGA executives and Local Government Finance Directors will oversee execution, with Chief Finance Officers and political groups retaining an advisory role. Once appointed, a Board of Directors consisting of three members elected by shareholders, two industry experts and two council finance directors may operate in a shadow capacity until launch. At launch the Board or Directors will formally take control of the Agency.

4.11 It is anticipated that two bonds will be issued in the first year with approximately 30 to 40 borrowers. For the initial bond issues at least, council borrowing requirements in terms of duration will need to match the bonds' maturity profiles.

4.12 The Agency staffing levels will start small and grow as the volume of transactions does. It is also anticipated that future developments might include a commercial paper programme for short term funding requirement for period up to one year. The exact mechanism and timelines for the execution of the bond are still to be clarified.

Investment Proposal

4.13 On 20th March 2014 the LGA Executive Board approved an LGA financial contribution towards mobilisation capped at £500k subject to match funding of £400k from Local Authorities. The finer details of the investment proposal have not been issued, however, Councils are now being asked to consider becoming a shareholder in the Agency and to provide a letter of intent to the LGA by 17th July, if they wish to proceed with an investment. Those Local Authorities that provide a letter of intent by this date will benefit from more favourable shareholder terms. It should be noted that if matching contributions from Local Authorities are not forthcoming by this date, the decision to proceed will expire and the project will not go ahead.

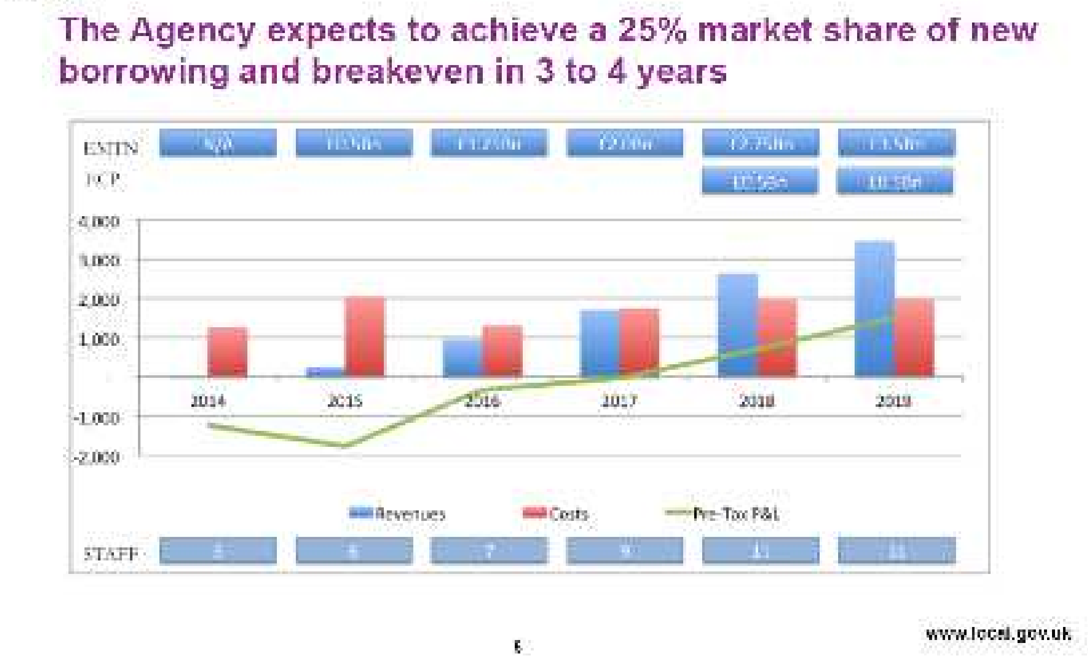
4.14 However if funds are successfully raised for the mobilisation phase Local Authorities will have a further opportunity, after the 17th July to become a shareholder as the LGA will continue to seek commitments up to launch, which is expected in the 4th quarter of this calendar year. In total £8m to £10m of capital is required to launch the Agency to cover early operating costs and provide a buffer against risks.

4.15 If the Council wishes to make an equity investment in the Agency and become a shareholder, it will need to establish whether to be an early investor and commit funds prior to the deadline of the 17th July, or wait to see whether the Agency does become more established and review the investment proposal later in the year.

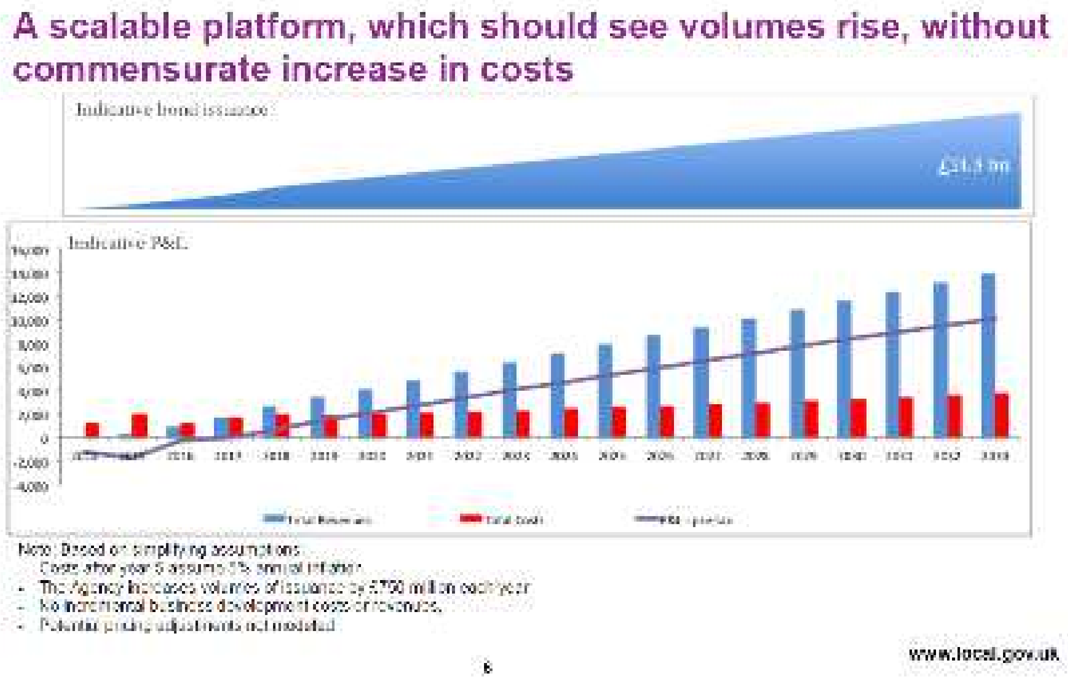
4.16 In accordance with regulations an equity investment of this nature would be defined as capital expenditure which the Council will finance from prudential borrowing. The ongoing revenue costs will be approximately 8.5% of the investment and in the short term be met by the Debt Charges budget, for example an investment of £200k would result in an annual revenue cost of approximately £17k. Once the Agency becomes profitable it is expected that dividends earned on the investment would offset these revenue costs.

4.17 An investment in Agency will require full Council approval, because the Treasury Management Strategy Statement, approved by Council does not cover equity investments.

4.18 The graphs below, taken from the LGA business case presentation, show the projected performance of the Agency over the next 5 years and indicative forecasts over the longer term.



Note: *EMTN = projected levels of bond issuance, *ECP = Commercial Paper



4.19 Indicative Net Present Value (NPV) calculations have been calculated based on the forecast profit and loss over a 20 year horizon and this shows an implied Internal Rate of Return (IRR) of between 10% and 11% depending on a dividend policy of 10% or 50% of post tax profit.

4.20 The Council should consider the investment in the Agency as a long term investment given that the agency only starts to make a profit in year 4. Shares in the Agency are likely to be transferable between Local Authorities so an exit from the investment and any value obtained would rely on demand from other councils.

4.21 All Local Authorities will have access to the Agency to raise borrowing whether they are equity investors or not, subject to meeting the criteria set by the Agency. It is envisaged that the interest rate paid by Councils that do not invest in the Agency will be on the same terms as those who have invested. However, the successful launch of the Agency is dependent on sufficient numbers of Councils making the investment and meeting the £8m to £10m that is required.

4.22 The investment opportunity is currently only open to Local Authorities and Local Authority Pension Funds.

Financial benefits of investing in the agency

4.23 There are two key drivers of value for making an investments

- Return on the equity investment, which comprises of the dividend stream and the valuation of shares held in the Agency
- Reduced financing costs, although as discussed earlier in the report, those Local Authorities who don't invest will still be able to use the Agency on the same terms to raise borrowing.

4.24 An investment in the Agency is not intended to increase overall borrowing for the Council, but to lower the cost of borrowing that is planned. The council is currently expected to raise £144m of borrowing over the next 5 years to support the capital programme. Using the Agency's business case estimate of savings of 0.20%, this would save the Council £288k in interest costs per annum.

4.25 As well as benefiting from lower borrowing costs, the Agency will provide an alternative to the PWLB and potentially a more stable mechanism to raise borrowing through the capital markets.

Risks

4.26 Making an investment in the mobilisation phase is of a higher risk because there is still a significant possibility that the large amount of capital required to launch the Agency does not materialise, rendering the initial investment worthless. However the risk is compensated by more favourable terms compared to an investment in the launch phase after the deadline of 17th July.

4.27 Other risks associated with making the investment and risks around the Agency itself are set out below:

- It may not be possible for the Agency to raise the required level of operating capital, either during mobilisation or launch phases.
- Local Authority demand for the Agency may not materialise in sufficient volumes. This may result in the Agency not being able to issue a bond of Benchmark size (£250m to £300m) or not at all.
- The new issue premium may erode all or part of the 0.20% to 0.25% savings, making the initial bonds less attractive for the Local Authorities in the first round of bond issues, and lead to reduced take up.
- Market pricing for any bond issuance may not be attractive. Until a bond is actively marketed to investors, the interest rate of spread above Gilts is uncertain and cannot be guaranteed ahead of time.
- In order to achieve the savings compared to PWLB set out in the Outline Business Case, it is expected that the Agency must obtain a AAA rating, the likelihood of which is uncertain especially in the early years and given that the UK Government is rated one notch lower by Fitch and Moody's.
- The Treasury could reduce the margin over Gilts for PWLB debt sufficiently to render the Agency unattractive for Local Authority borrowing.
- The principle of joint and several guarantee which the Council would have to agree to, is the main contributing factor to achieving the savings of 0.20% to 0.25% compared to the PWLB rates. It is uncertain whether the view from the market would support these levels of savings.
- It is uncertain whether the Agency has the flexibility to meet the borrowing demands of the initial 30 to 40 Local Authorities in the first bond issuance, where all borrowers will be required to have similar maturity profiles.
- Given that we are now in a low interest rate environment where the base rate may not return to much more than 3% over the coming years, this may undermine the attractiveness for long dated borrowing and therefore the forecast pipeline of bond issues undertaken by Agency and its profitability.
- The Agency may be unable to attract personnel of sufficient calibre.

4.28 In addition, initially there is likely to be a more lengthy process for councils when raising borrowing and the conditions set by the Agency that need to be met. A council may have to commit to raising funds a month or 6 weeks before the funds are received during which there is an increased risk that interest rates could move significantly.

Summary

4.29 Finance accessed through the capital markets via the Agency could provide an alternative form of borrowing for Local Authorities at a time when there is greater uncertainty how the Treasury set the rates and terms of PWLB loans.

4.30 The main benchmark bond issues which we can compare the Agency's Business case against on an appropriate basis are those issued by the Transport for London and the Greater London Authority. They have generally issued between 0.60% and 1.0% over the equivalent gilt, with more recent issues achieving closer 0.60%, which would equate savings of 0.2% compared with the PWLB. However as discussed there is uncertainty around the pricing until a firm proposition is put to the market.

4.31 Initially, at least, bonds issued by the Agency for Local Authorities are likely to require longer timescales to raise borrowing compared to the ease of interacting with the PWLB.

4.32 The Council effectively have two options available to them at this point: -

- Take no further part in the process at this point, but monitor progress made by the Agency and review the investment proposal later in the year, albeit on less favourable terms. Decide whether to use the Agency for borrowing purposes when, and if, the funding has been secured.

- Make a commitment to become an equity stakeholder before the 17th July deadline, with a sum to be agreed in principle and forward to Council for approval.

4.33 Whilst being supportive of the general principles of the Agency it should be noted that this is a start up proposal with a very real risk that some or all of the equity investment may be lost if the Agency fails to succeed and the financial benefits of being an equity holder are not well demonstrated or clear cut. However, there could be long term financial benefits to the Council of holding equity in the Agency but it is also a relatively high risk investment where the risks and rewards are finely balanced.

4.34 The Council will continue to participate in discussions with the LGA and review Supportively future proposals should the market environment and/or the business case change.

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

This report provides information on performance against the Treasury Management Strategy. Section 7 shows the impact of treasury decisions which are driven by capital spend on the Council's revenue budget.

6.2 Statutory, Risk and Legal Implications

The risks of investment in the LGA Bond Agency are described in the body of the report.

6.3 Equality and Diversity Implications

There are no significant implications within this category.

6.4 Engagement and Consultation Implications

There are no significant implications within this category.

6.5 Localism and Local Member Involvement

There are no significant implications within this category.

6.6 Public Health Implications

There are no significant implications within this category.

Source Documents	**Location**
LGA Business Case Documents	
• LGA Municipal Bond Agency Summary 20th March 2014	Link to document on LGA website
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• LGA Municipal Bond Agency Report March 2014	Link to document on LGA website
Other Documents	
• Municipal Bonds Questions and Answers	Link to document on LGA website