Report to	Cabinet	**Item**
	10 September 2014	10
Report of	Chief finance officer	
Subject	Potential investment in the UK Municipal Bonds Agency	

Purpose

To consider the Local Government Association (LGA) UK Municipal Bond Agency and investment proposition.

Recommendations

Approve the investment of £50,000 in the mobilisation phase of the UK Municipal Bonds Agency, and up to a further £50,000 in the implementation phase.

Corporate and service priorities

The report aims to meet the corporate priority value for money services.

Financial implications

The report recommends the one off investment of up to £100,000 to an initiative aiming to reduce local authority borrowing costs in the future.

Ward/s: All wards

Cabinet member: Councillor Waters – Deputy leader and resources

Contact officers

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Background documents

None

Report

Background

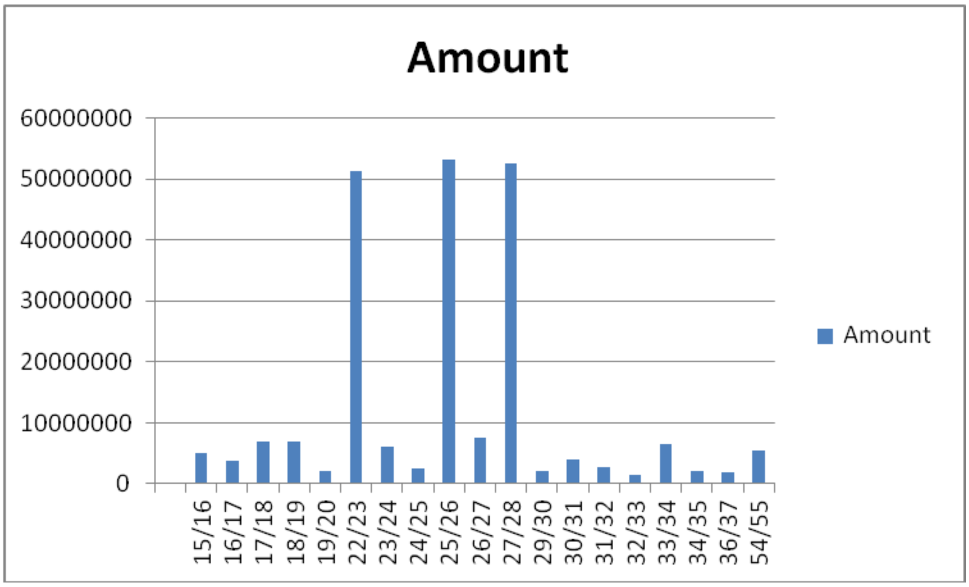
1. Local Authority Bonds started to come back into the spotlight in October 2010, when the Chancellor unexpectedly announced in the spending review, that Public Works Loan Board (PWLB) rates would increase to 1% above gilts from 0.15%, which significantly increased the cost of borrowing to councils overnight.
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 of 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.
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.
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 increased certainty of terms, is free of central government control and with potentially lower rates than available from other sources.
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 some of the advantages and risks associated with it against the backdrop of the council's current borrowing and future borrowing projections.

Current sources of long term borrowing

6. At 31 March 2014 the council had long term borrowing of £224.8m of which £218.9m was with the Public Works Loans Board (PWLB) and £5.3m with UK banks. 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.
7. Borrowing via these routes can be secured at short notice and are governed by the council's treasury management strategy 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.

Current borrowing and projections

8. The council can take out loans in order to fund spending for its capital programme for the benefit of Norwich. 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.
9. The chart below shows the maturity profile of borrowing, with £84.77m maturing in the next 10 years, all of which is likely to be refinanced.



10. The projected increase in borrowing over the next 3 years was set out in the treasury management strategy approved by council in February and is set out in the table below.

Year	2014-15	2015-16	2016-17
Projected increase in borrowing	£20.0m	£19.9m	£29.2m

LGA UK MUNICIPAL BOND AGENCY

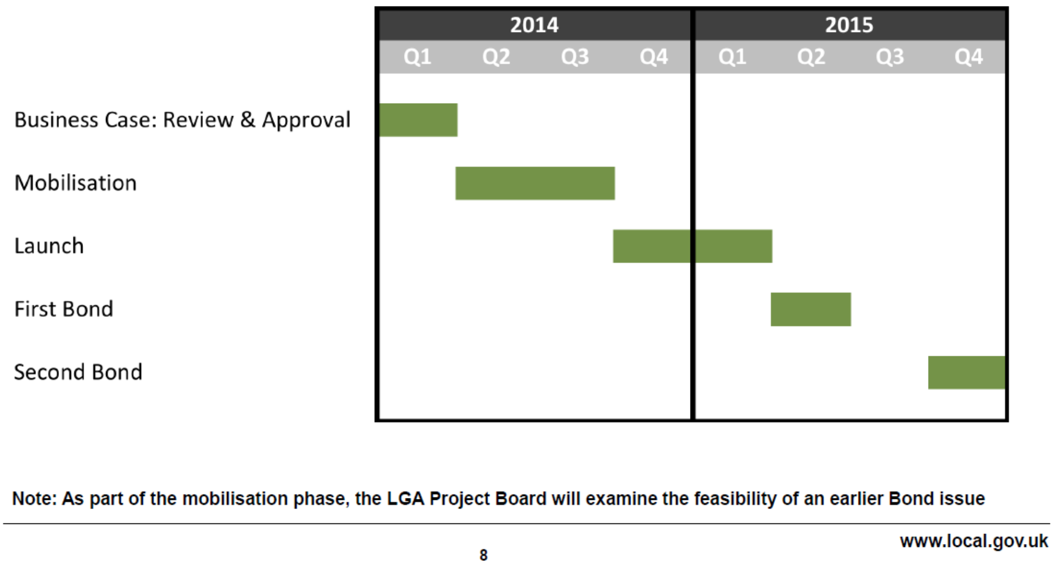
Introduction

11. Councils source 75% of their borrowing from the PWLB and are therefore vulnerable to the interest rates set by the Debt Management Office (DMO) through the government. The Bonds 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.
12. Local authorities who raise borrowing through the agency will need to meet credit criteria set by the agency. Experience in other countries has shown

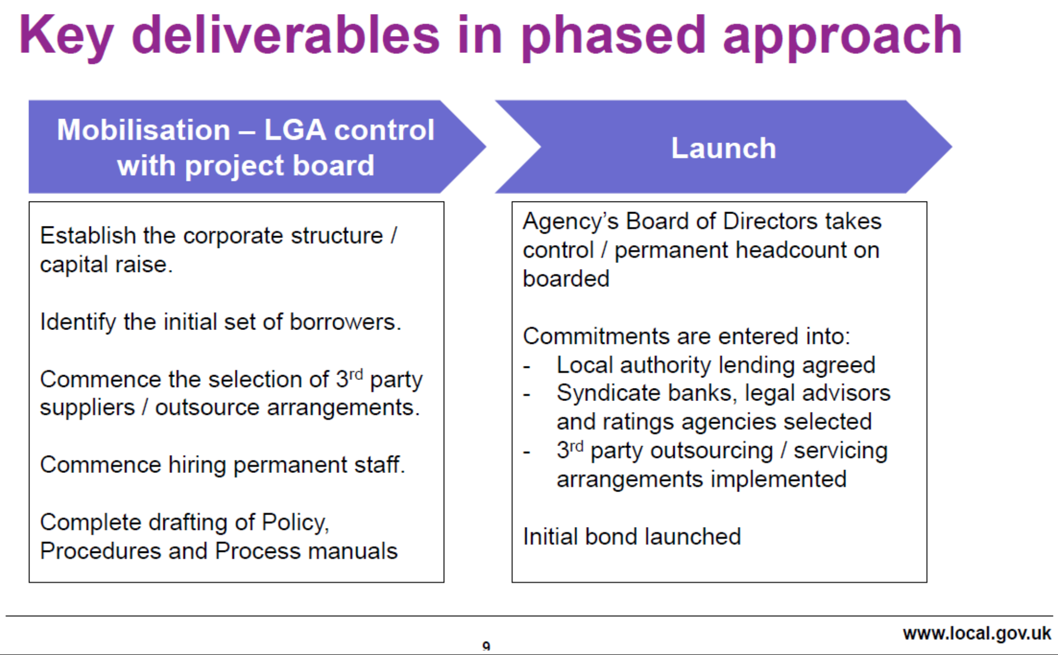
that an agency’s credit processes, with the incentive of lower borrowing costs and the oversight of peers, has strengthened the overall credit worthiness of local authorities as a whole.

Summary of revised business case

13. 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.
14. 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.
15. 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.
16. The business case explains the protections in place for guarantors which include:
    a) 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.
    b) English law contains a number of protections such as right of indemnity, which help ensure that guarantors can recover repayments they make under the guarantee.
    c) Proportionality / right of recourse or equivalent which ensures that in the event of any loss the amount in default is distributed proportionately amongst the providing the guarantee.
    d) In the event a guarantee is called, creditors will still have access to the high court process which enables a high court appointed administrator to take control of certain aspects of a local authority’s finances.
17. 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 investors. The savings identified compared to PWLB 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.
18. The proposed timetable to issue the first LGA agency bond in March/April 2015 is shown in the table below.



19. 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.



20. 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 of directors will formally take control of the agency.

21. 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.

22. 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.

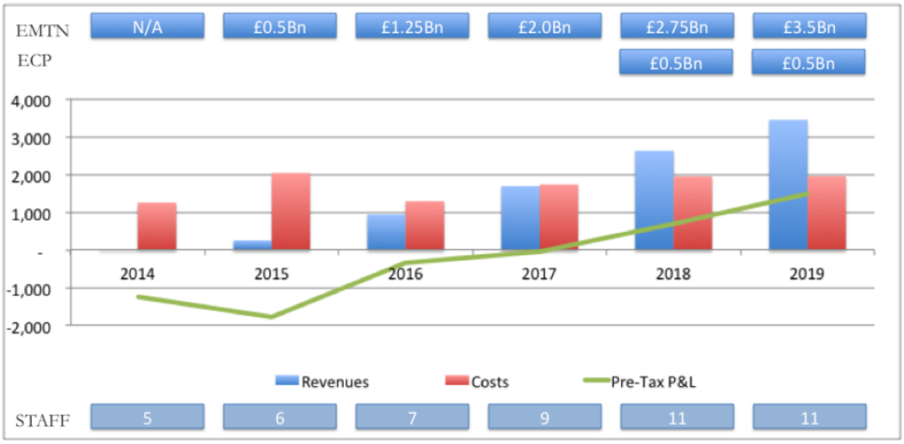
Investment proposal

23. On 20 March 2014 the LGA executive board approved an LGA financial contribution to mobilisation, capped at £500k. Match funding of £400k was sought by mid-July from local authorities, the investment being in the form of an equity shareholding. To encourage investment from smaller councils, there was no minimum level of investment required from an individual authority. However, the following investment levels were suggested:
    a) £10,000 to £50,000 for smaller authorities;
    b) £50,000 to £150,000 for medium sized authorities; and
    c) £200,000 to £300,000 for larger authorities.
24. The intention was that if funds were successfully raised during the mobilisation phase, a further investment in the launch phase would be required of £8m to £10m and again this will be in the form of an equity shares. This capital will be used to cover early operating costs and provide a buffer against risks.
25. On 11 August the LGA wrote again to councils setting out the success of the match funding exercise to date and extending the deadline for expressing interest in investing in the mobilisation phase to 31 August 2014.
26. In the LGA's words "Within just over a month, 33 councils sent letters of intent with total commitments of £3.4 million (Phase 1: £1.6m, Phase 2: £1.8m), significantly exceeding our target. However, since 17 July the momentum behind the agency has continued to build and we have received a number of requests for an extension to the deadline, which the project board has carefully considered. After much deliberation the board has recommended that the benefits to the project overall, and therefore to each of the councils that have already committed, justify an extension to the deadline. To give councils a chance to respond in this holiday season it has been decided to extend the deadline for returning letters of intent to invest in phase one to midnight on 31 August 2014."
27. Following discussion with the leader and portfolio holder, officers have submitted a letter of intent on behalf of Norwich City Council indicating up to £50,000 of investment in the mobilisation phase and up to a further £50,000 in the launch phase, subject to council approval. It is clear that this letter is not, and is not meant to be, legally binding. However, its submission leaves the path open for the council to invest in the agency at the mobilisation phase should it choose to do so. The deadline for returning the legally binding subscription agreement confirming the phase one investment and reaffirming the intended phase two investment is 30 September 2014."
28. An investment would be held in the balance sheet as an available for sale financial asset, under current accounting requirements. This means changes in the valuation of the share capital do not impact the income and expenditure account, but instead are held in the available for sale reserve on

the balance sheet. However if it became apparent the share capital had no value the investment would need to be written off to the income and expenditure account.

29. The slides 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.

The Agency expects to achieve a 25% market share of new borrowing and breakeven in 3 to 4 years



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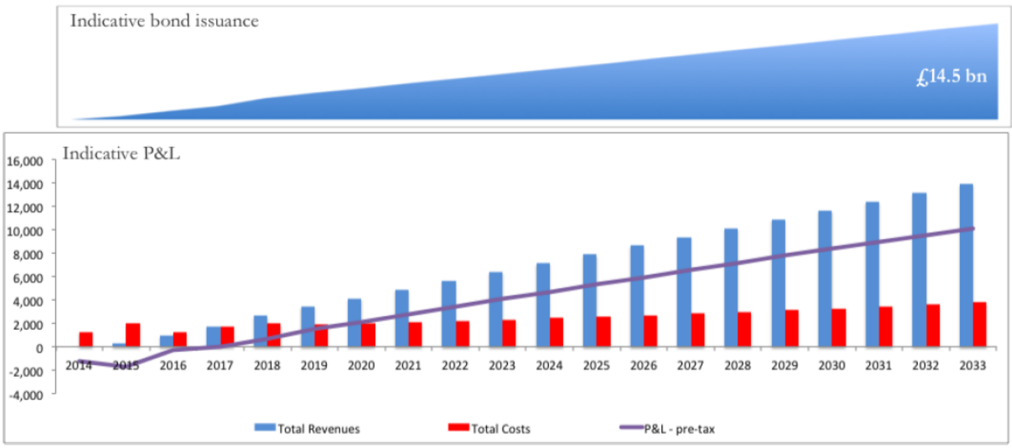
Note: *EMTN = projected levels of Bond issuance, *ECP = Commercial Paper

A scalable platform, which should see volumes rise, without commensurate increase in costs



Note: Based on simplifying assumptions:
- Costs after year 5 assume 5% annual inflation
- The Agency increases volumes of issuance by £750 million each year
- No incremental business development costs or revenues,
- Potential pricing adjustments not modeled

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30. 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.

31. Clearly, 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 3. 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.

32. 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 don't invest in the agency will be on the same terms as those who have invested.

33. The investment opportunity is currently only open to local authorities and local authority pension funds.

Benefits of investing in the agency

34. There are two key financial drivers of value for making an investment

    a) Return on the equity investment, which comprises of the dividend stream and the valuation of shares held in the agency

    b) Reduced financing costs. 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.

Risks

35. Making an investment in the mobilisation phase is of a higher risk because there is a possibility that the large amount of capital required to launch the agency does not materialise, rendering the initial investment worthless.

36. Other risks associated with making the investment and risks around the agency itself are set out below:

    a) It may not be possible for the agency to raise the required level of operating capital, either during mobilisation or launch phases.

    b) 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.

    c) The new issue premium may make the initial bonds unattractive for the local authorities in the first round of bond issues, leading to reduced take up. Councils would also need to consider potential value for money audit issues, if they proceeded where PWLB rates were cheaper.

    d) 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.

    e) In order to achieve the savings compared to PWLB set out in the OBC, it is expected that the agency must be able to obtain an AAA rating, the likelihood of which is uncertain especially in the early years and given that the UK Government has AA+ rating from Fitch.

    f) The Treasury could reduce the margin over gilts for PWLB debt sufficiently to render the agency unattractive for local authority borrowing.

    g) The principle of joint and several guarantees, 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.

h) 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.

i) 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.

j) The agency may be unable to attract personnel of sufficient calibre.

37. In addition 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

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

39. There are significant risks and uncertainties in the business case for the agency in achieving a saving compared to PWLB. Investment in the agency would not comply with the council's treasury management strategy which requires a much higher level of security, and indeed this investment may not achieve a return at all. However, the setting up of the agency is about the sector building lending capacity itself and providing competition in the lending market with the express intention of driving down lending costs for local authorities.

40. Norwich City Council has, and will continue to have, significant borrowing needs over the coming years and if the agency is successful in its drive to reduce borrowing rates this could be of significant benefit to the council.

Integrated impact assessment

NORWICH City Council

Report author to complete	
Committee:	Cabinet
Committee date:	10 September 2014
Head of service:	Chief Finance Officer
Report subject:	Potential investment in the UK Municipal Bonds Agency
Date assessed:	19 August 2014
Description:	This is the integrated impact assessment for the potential investment in the UK Municipal Bonds Agency

	Impact			
Economic (please add an ‘x’ as appropriate)	**Neutral**	**Positive**	**Negative**	**Comments**
Finance (value for money)	☐	☒	☐	The report recommends a one off investment of up to £100,000 to a sector led initiative aimed at reducing borrowing costs for Local Authorities in the future. However, there are risks associated with the investment and the outcome of reduced borrowing costs may not be achieved.
Other departments and services e.g. office facilities, customer contact	☒	☐	☐	
ICT services	☒	☐	☐	
Economic development	☒	☐	☐	
Financial inclusion	☒	☐	☐	
Social (please add an ‘x’ as appropriate)	**Neutral**	**Positive**	**Negative**	**Comments**
Safeguarding children and adults	☒	☐	☐	
S17 crime and disorder act 1998	☒	☐	☐	
Human Rights Act 1998	☒	☐	☐	
Health and well being	☒	☐	☐	
Equality and diversity (please add an ‘x’ as appropriate)	**Neutral**	**Positive**	**Negative**	**Comments**
Relations between groups (cohesion)	☒	☐	☐	
Eliminating discrimination & harassment	☒	☐	☐	

	Impact			
Advancing equality of opportunity	☒	☐	☐	
Environmental (please add an ‘x’ as appropriate)	**Neutral**	**Positive**	**Negative**	**Comments**
Transportation	☒	☐	☐	
Natural and built environment	☒	☐	☐	
Waste minimisation & resource use	☒	☐	☐	
Pollution	☒	☐	☐	
Sustainable procurement	☒	☐	☐	
Energy and climate change	☒	☐	☐	
(Please add an ‘x’ as appropriate)	**Neutral**	**Positive**	**Negative**	**Comments**
Risk management	☒	☐	☐	

Recommendations from impact assessment
Positive
None
Negative
None
Neutral

None
Issues
The council should continue to monitor its treasury management strategy, including borrowing needs, in the context of the financial risk environment within which it operates.