**Briefing note on the proposed scheme for a Municipal Bonds Agency**

**To Finance Scrutiny Panel**

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**Background**

Led by the Local Government Association work to establish a Municipal Bonds Agency finally got under way in 2014. The single purpose of the LGA is to reduce councils' capital costs over the long term which it will do by:

* Raising money on the capital markets through issuing bonds
* Arranging lending or borrowing directly between local authorities
* Sourcing funding from other third party sources such as banks, pension funds and insurance companies –

It aims to be able to lend to eligible councils at a lower rate than the PWLB or than if the councils were to issue their own bonds. This lower rate will be attained by:

* Achieving a AAA/sovereign-like credit rating through a joint and several guarantee (see section 6 of the business case) and adequate risk capital of three to five per cent of the total volume of bonds (see section 4.6.2.8 of the business case).
* Issuing bonds in benchmark sizes of £250 million to £300 million.
* Sourcing capital at low interest rates from third parties

Forty Councils have now joined the Agency and have raised over £4.5 million to enable the agency to be set up and the first meeting of the future shareholders has now been held. The target is £8 - £10 million.

This is a new cash lending facility which will compete directly with other sources of funding, including that offered by PWLB, and it is expected that the Agency will issue its first bond in April 2015.

Expressions of interest have been sought from Councils in respect of either borrowing from the facility at a later date or providing initial capital for the venture.

**Setup**

The agency, trading under the name Local Capital Finance Company, will be an independent company owned by Local Government with the sole aim of reducing financing cost for Councils. LGA are project sponsors and therefore control Governance. It will be a limited company with its own Board of Directors from local authority finance backgrounds.

Participating authorities will be local authorities that invest in the setting up of the Agency or invest risk capital to capitalise the Agency and fund it through its early years. Those authorities that invest in its establishment will own and will become shareholders in the Agency and have a say in how its run. It is envisaged that the risk capital invested will be returned to authorities after 10 years of successful operations having earned interest at commercial rates.

Authorities will still have the opportunity to invest in the agency throughout the rest of the year to complete the raising of the capital required.

It is anticipated that once the Agency is generating sufficient profit, it would be able to start paying a dividend to investors, while delivering economic benefits to borrowers. Its shares will be transferrable and therefore a council could sell its shares to other local authorities or eligible public bodies.

Providers of finance will need to undergo a credit process. This will underpin the agency’s credit rating, enabling the agency to achieve good interest rates. The credit process will be tailored to Councils and the Agency and will not be excessively onerous.

A joint and several guarantee creates the prospect of much cheaper borrowing. It will also enable the bonds to be listed on the London Stock Exchange. Overall it could reduce the borrowing costs by 20 to 25 bps.

The agency will have in place a credit process, underpinned by on-going monitoring; risk and liquidity capital; and a right of recourse, which will ensure, in the event of the guarantee being called, that it will be applied proportionally. Even if the guarantee was to be called, creditors would be confident of receiving their money back in time. The protections available would be stronger than currently apply in the case of inter-council lending. Nevertheless, no local authority has ever defaulted and for the joint and several guarantees to be called an unprecedented situation would have arisen.

**Process**

The agency will raise capital on the financial markets through the sale of bonds and on lend the proceeds to eligible Councils at a lower rate than the PWLB or than if Councils were to issue their own bonds.

This lower rate will be attained by:

* Achieving a AAA/sovereign like credit rating through a joint and several guarantee and adequate risk capital of three to five per cent of the total volume of bonds
* Issuing bonds in benchmark sizes of £250m to £300m

The agency’s operating capital should be raised from Councils or related bodies as common equity. An equity structure would allow the trading of shares and give the Agency a decision making framework over profit retention and dividends.

The agency would issue two bonds in its first year with approx. 30-40 borrowers. Council borrowing will need to match the bonds maturity profiles in the initial issue.

Councils have been advised that they will need to set out details of their long-term borrowing plans if they take borrowing from the agency

**Risks**

The main risk is that the agency is not able to raise the initial operating capital required to set up.

Other risks are market pricing, including the price of bond issue; the ability and likelihood that PWLB will reduce its rates to make them more competitive. Is there enough Council demand to use this vehicle to borrow and can the agency attract enough of the right calibre of personnel to administer it and provide the governance it requires.

**Treasury Advisors View**

This is a good idea and a scheme that could work, but a fear is that PWLB will reduce their rates to match or better the borrowing offered by this scheme.

A number of other questions have also been raised by Sector, around the demand for this facility and the timing of the availability of the borrowing, when the current market is in a low interest rate environment. This is not the right time in the interest rate cycle to be lending long-term, this is based on various interest rate forecasts that long-term rates will increase over the medium to longer term.

The Joint and Several guarantee raises questions over whether it will provide a lower rate borrowing.

The agency is expecting to achieve a AAA sovereign rating, however the UK no longer holds a AAA rating by all three agencies, therefore there is a risk that this may not be achieved.

**Conclusion**

The establishment of a Municipal Bonds Agency gives the opportunity for the Council to invest as well as borrow. The following points are worthy of note with regard to each area:

Investments

* Funds provided by Local Authorities are expected to be tied up for 10years with no guaranteed return, or even an estimate of the expected rate of return is provided.
* The risk of undertaking long term investments with speculation of rising interest rates is high if the interest rate is to be fixed.
* The Council has recently invested a further £7 million of its existing cash surpluses in an additional indirect property fund, bringing the total invested in such funds to £10 million. This surplus cash is likely in itself to be invested long term for a similar period to that of the municipal bond.
* The Council’s Treasury Management Strategy categorises any investment more than 365 days as a non-specified investment. The percentage of non- specified investments under the current Strategy is restricted to 25 % of the portfolio which is taken up in indirect property funds. Any move to increase this level of investment in non-specified funds, if it were to be recommended, would require Full Council approval.

Borrowing

* The Council has no requirement to externally borrow to finance its capital programme Our internal borrowing – difference between CFR £220m and our actual borrowing £202m is £18m, and whilst does give us the ability to externally borrow with current PWLB rates of approximately 4% and investment interest earned at a rate of around 1% the case for not doing so is compelling.
* The Councils need to borrow may change should the Council use its existing borrowing headroom on the HRA, of £36 million, or should it be awarded additional borrowing headroom to fund additional new house build arising from a recent bid to DCLG.
* The rate at which borrowing would be undertaken is uncertain and may not be as favourable as PWLB.

The financial implications of either investing in or borrowing from the Municipal Bond Agency are still to be clarified. The long term investment of sums in the agency is a risk in the current financial climate and would require Council approval. The Council does not have a requirement for new external borrowing at this point in time and to do so would have an adverse financial impact on the Council. The Councils advisors, Capita, advise that the Council should wait for further clarification before becoming involved which is one that I would share and recommend. The position should be monitored and should the Councils requirement to borrow change in the future and the rates are better or comparable than other sources such as PWLB then this should be considered at the time.

**Councils expressing an interest in creation of Bond Agency**

The 18 Councils that have made a formal expression of interest in the creation of a Bond agency are:

* Birmingham City Council
* Cheshire West and Chester Council
* City of London Corporation
* East Dunbartonshire Council
* Ipswich Borough Council
* Lancashire County Council
* London Borough of Lewisham
* London Borough of Southwark
* London Borough of Sutton
* London Borough of Richmond upon Thames
* Newcastle City Council
* Rochford District Council
* Stevenage Borough Council
* South Cambridgeshire District Council
* Warrington Borough Council
* Westminister City Council
* Royal Borough of Kensington and Chelsea