

Municipal Bonds Agency: Report to 20 March Executive

Purpose

For decision.

Summary

The Executive commissioned in November a review of the January 2012 Outline Business Case for a Municipal Bond Agency. The business case review produced by our expert advisers confirms that there is a strong public interest and economic case for establishing a Municipal Bonds Agency. The review also introduces revisions to the business case and sets out proposals on how it could be operationalised. The most significant revisions are:

- (i) a proposal that borrowers from the Agency should enter into a joint and several guarantee of its borrowings;
- (ii) a revised and simplified model for the Agency's capital structure based on councils and the LGA taking conventional equity shareholdings; and
- (iii) as part of the latter, a significantly higher operating capital requirement than previously suggested.

The report recommends that the Executive now authorise a move into a mobilisation phase, which will require a budget of up to £1 million provided by potential shareholders, including the LGA, and which would lead into the launch of the Agency in the autumn of this year. Further approval for the LGA to proceed into the launch stage would be sought at the end of mobilisation. The LGA would continue to lead the project through mobilisation and would establish a formal project board subject to the Leadership Board's oversight to manage that progress.

Recommendations

That the Executive:

1. Endorse the findings in the revised business case and approve its publication. (paragraph 8)
2. Authorise a move into the mobilisation phase of the project. (paragraph 13)
3. Approve an LGA financial contribution to the mobilisation phase, capped at £500,000. (paragraph 20)
4. Agree that the conditions for that contribution are:
 - a. that £400,000 should be equally matched by contributions from councils;
 - b. that it should be reflected in an equity stake in the Agency; and
 - c. that the equity stake should have a value that could be reflected as an asset maintaining the LGA's net balance sheet position (paragraph 20).

5. Agree that if matching contributions from councils are not forthcoming by July, the decision to proceed will expire and the project will not proceed further. (paragraph 20)
6. Agree to the LGA constitution being amended at July's General Assembly to put beyond doubt the LGA's ability to invest in shares on behalf of its members in this way. (paragraph 22-24)
7. Delegate authority to the Project Board to direct the project and make the decisions set out at paragraph 14, and delegate to the Leadership Board authority to make decisions on matters brought to it by the Project Sponsor/Senior Responsible Officer. (paragraph 16)

Action

Officers to implement the decisions of the Board.

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Background

1. Members will recall that the Executive of January 2012 endorsed the publication of an outline business case for a Municipal Bond Agency (MBA). The Executive took the project into a new phase in the summer of 2013 with the publication of *Rewiring Public Services* which included a pledge to *boost investment in infrastructure by re-creating the thriving market in municipal bonds which England once had and most other countries still have*. At last July's Conference, the Chairman invited councils interested in the project to confirm their support as a first precondition of making further progress. Nearly 40 councils expressed support, 18 of them publicly.
2. The November 2013 Executive therefore approved a move to phase two of the project, which was planned to focus on a review of the outline business case (OBC). In December Aidan Brady, a chartered accountant and senior executive from the banking sector was appointed as Lead Adviser to the project, supported by two strategic advisers; Francis Breedon, Professor of Economics and Finance at Queen Mary College, University of London; and Lars Andersson, the founder and first Chief Executive of Kommuninvest, the Swedish Agency. The expert team has been supported by LGA officers and by an expert finance officer kindly loaned to us by a member council, and has commissioned further advice including from law firms and leading counsel. It has also been supported by a working group of council finance directors and a political-level steering group consisting of council leaders.
3. The Advisory Team's two-month review, under Aidan Brady's leadership, has:
 - 3.1. refreshed and further developed the public interest case for setting up an Agency;
 - 3.2. engaged with councils, along the way identifying a borrowing requirement over the next three years of £4.9 billion from 40 councils alone;
 - 3.3. held discussions with the six leading banks engaged in the handling of bonds;
 - 3.4. held discussions with three principal ratings agencies;
 - 3.5. sought legal advice on the operation of a joint and several guarantee in the event of a default and vires issues; and
 - 3.6. discussed governance and capital structure at both officer and political level.

This has resulted in the development of the revised business case attached at **Appendix B**. A short summary of the report is attached at **Appendix A**.

What the revised business case confirms and what it changes

4. The revised business case confirms:
 - 4.1. that a MBA could deliver savings on councils borrowing costs compared to alternatives;
 - 4.2. that there are a range of other potential benefits to councils as borrowers from an agency; and
 - 4.3. that it is feasible and within council vires to set an agency up in the short term.

5. The revised business case also develops the analysis in the OBC. In particular, it sets out a market entry and development strategy for the Agency and a target bond issuance profile for the early years. It envisages the Agency developing its functionality over time and describes how it might do that (the original OBC set out a full range of services and an accompanying cost base which would neither be wanted nor feasible on Day One). It also models the Agency's profit and loss account over the first few years of operations. The revised business case also gives much more detail on the considerations which are likely to drive the pricing of the Agency's bonds, and draws conclusions from that about its structures and operations.
6. Building on that more developed analysis, the revised business case also proposes a number of revisions to the original OBC. The most significant are:
 - 6.1. a proposal that the Agency's operating capital should be in the form of conventional equity, which would mean councils and the LGA, if it were an investor, being shareholders;
 - 6.2. a significant upward revision, to £8-10 million, of the operating capital requirements needed to set the Agency up and get it to break-even point;
 - 6.3. a proposal that the Agency should, initially at least, contract out its operations rather than buying IT and employing a lot of staff;
 - 6.4. a revised and much cheaper model for holding risk capital against the risk of default on the Agency's bonds (by holding back capital against individual bond issues at the time they happen); and
 - 6.5. a revision of the OBC's judgement against using a joint and several guarantee among borrowers to secure the Agency debt; this is based both on clearer and very robust legal advice about guarantees, and on the significant interest savings this model would make possible. The advice made clear that such guarantees were within the vires of English councils under the General Power of Competence, but not other UK councils or authorities, such as Fire and Rescue or National Parks Authorities.
7. The revised business case implies that if half of the outstanding debt with the Public Works Loans Board were to be transferred over time to the Agency, the net present value of potential saving to borrowers as a whole from establishing the Agency on this basis could be between £1.2 billion and £1.45 billion over 30 years.
8. We recommend that the Executive endorse the report and agree that it be published.

Timeline

9. The revised business case recommends that the Agency issues its first bond in March/April 2015 in order to satisfy councils' demand for borrowing at that time of the year. To attract the best pricing the bond would need to be for a minimum of £250 million to £300 million. The route to issuing the first bond will be via a six month mobilisation phase (March - September 2014) followed by a six month launch phase (September 2014 – March 2015).
10. There will be further decision gateways within and at the end of the Mobilisation phase, as well as before launching the first bond. The revised business case sets out the start-up investment at risk at each gateway point.

Mobilisation

11. The mobilisation phase of the project described in section 11.2 of the revised business case will entail the following work:
 - 11.1. Drawing up a shareholder agreement, recruiting shareholders and raising the £8 million - £10 million needed to launch and operate the Agency in the early years.
 - 11.2. Promoting the Agency and recruiting the first borrowers.
 - 11.3. Designing key policies and procedures.
 - 11.4. Establishing the corporate structure.
 - 11.5. Drafting articles of association
 - 11.6. Preparation of documents eg loan documentation.
 - 11.7. Recruiting and establishing the initial board of directors and recruiting key personnel e.g. Chief Executive Officer, Chief Risk Officer and Chief Finance/Accounting Officer.
12. Undertaking this work would require the recruitment in the short term of a small team (3-4) of experienced contractors.
13. This paper seeks approval to move into the mobilisation phase.

Governance

14. Mobilisation. Early in the mobilisation phase it is proposed to set up a project board selected by the LGA, consisting of no more than 5 to 7 members, including LGA executives, the project sponsor and council treasurers. It may include future members of the initial board of directors. The Project Board would be constituted with appropriate terms of reference and meet at least every other week during mobilisation. The Board would be responsible for:
 - 14.1. Overseeing execution of the project to go live.
 - 14.2. In conjunction with the LGA, selecting the initial board of directors.
 - 14.3. Determining, in consultation with the board of directors when appointed, the point at which the project would move into the launch phase.
15. As the project moves towards launch the board of directors may increasingly act as a shadow board and would be consulted on major decisions. Regular meetings would continue to be held with the Leaders or their representatives and senior finance officers of interested councils. These meetings would be used to consult on and discuss proposals and to keep shareholders and potential shareholders informed of progress. The advisory role of these groups will continue to be instrumental in moving the project forward. It is envisaged that the LGA would retain control at this stage.
16. In accordance with conventional project management practice the Project Sponsor/Senior Responsible Officer will act as the interface between the Project Board and the LGA's decision making frameworks. In order to enable speedy decision making and ensure that the project remains on track the Project Board should receive delegated authority to take decisions in order to fulfil the functions at paragraph 11 above. It is also recommended that the Executive delegate to the Leadership Board authority to make

decisions referred to it by the Project Sponsor. Regular progress reports will be made to the Leadership Board throughout the mobilisation phase. We recommend that the Executive endorse this approach.

17. Launch. At launch, voting rights would adjust to individual shareholding in accordance with the voting rights structure set out in the Shareholder Agreement, and governance of the Agency would be normalised with the Board of Directors taking control of the Agency. It is anticipated that the Board would consist of seven non-executive directors:

- 17.1. Three elected by shareholders and include the chair.
- 17.2. A technical expert in the debt capital market.
- 17.3. A technical expert in risk management.
- 17.4. Two council finance directors or equivalent.
- 17.5. The CEO may also be a director.

18. A nominations committee would make nominations of experts to the board; the three elected board members will be elected by a ballot of shareholders. While all members of the board require shareholder approval, it is for consideration that the LGA may reserve swamping rights in the election of certain board members; and also in changes to articles of association; and over changes in control (ie pre-approval of transfer of shares).

Risk

19. There are three overriding risks to the project:

- 19.1. It may not be possible to raise the required operating capital. This can be mitigated by continued promotion of the investment opportunity the Agency presents to councils and by the LGA's own overt in kind support for the Agency.
- 19.2. Council demand for borrowing from the Agency may not materialise in sufficient volume. Continued promotion to councils will also be important for mitigating this risk, as will promoting the bonds in the capital markets. Demand may also be affected by wider political sentiment toward the Agency and it will remain important therefore that elected members continue to promote the Agency through their own political channels.
- 19.3. Unattractive market pricing for bond issuance. This could be caused by market movements outside the control of the Agency or by the Agency being unable to achieve appropriate credibility in the market place. Not being able to attract personnel of a suitable calibre to the Agency could also harm the chances of achieving the desired credit rating and so recruiting the right high calibre personnel to the Agency will be vital. Although the idea of a Municipal Bonds Agency has been well received in the City, with banks being confident of a positive market for municipal bonds, it will nonetheless be important to promote the Agency as we move towards the first bond issue to build credibility with the market makers.

Future role of the LGA

20. Further financial contribution. Since the project was re-launched last summer the LGA has committed £150,000 of programme budget in this financial year. It is estimated that the mobilisation phase will require a further investment of £800,000 to £1 million: we suggest the LGA should be willing to fund half of that. To date councils and related bodies have not been asked to make a financial contribution to the setting up of the Agency, and the development of shareholder agreements is a planned activity for the mobilisation phase. This means that for the momentum of the project to be sustained, further LGA investment will be required. Subject to the Executive agreeing that the project should proceed therefore, it is recommended that the LGA commit a further £500,000 to enable the mobilisation phase to get underway without delay. It is further recommended that this investment be subject to:
- 20.1. £400,000 of the investment being equally matched with contributions from councils and related bodies.
 - 20.2. It being reflected in an equity stake in the Agency that recognises the risk taken by the LGA in investing in the agency at this early stage. This stake would be subject to negotiation with other shareholders.
 - 20.3. The equity stake having a value that could be reflected as an asset on the LGA's books, so as not to worsen our net reserve position.
21. So as not to delay the start of the mobilisation phase and to sustain the momentum of the project, it is proposed that the first £100,000 of the investment should not be conditional on matched funding having already been committed. If matched funding fails to materialise by mid-July, the project will not proceed.
22. LGA shareholding. In return for its investment in the establishment of the Agency, the LGA would be issued shares not only reflecting its financial commitment, but also its financial risk from being the initial investor. It is envisaged that these shares would be a tradable asset enabling the investment to be redeemed in due course. As mentioned above, it is for consideration that the LGA would hold certain swamping rights, which would need to be agreed during the mobilisation phase, with the risks to the LGA, if any, of holding these rights identified for later consideration by the Board.
23. In holding these shares, it will be important for the LGA to avoid any conflict of interest that might arise from having a commercial interest in the Agency, while at the same time having the right to control a number of Board appointments and other issues. In addition, in certain circumstances, it may be in the interests of the LGA, from a commercial perspective, to liquidate its holdings, whereas it may not be in the interests of the Agency itself for that to happen. Accordingly, the LGA will need to satisfy itself that appropriate controls and ring fences can be implemented.
24. Currently the LGA's Constitution, and its status as an unincorporated association, means that there are questions about our ability to hold shares in this way as an investment. To put this beyond doubt, we have been advised that the Constitution of the LGA will need to be amended to include such powers, and appropriate delegations and indemnities will need to be put in place to facilitate this. We recommend that such a change be accomplished at the July General Assembly.

25. LGA risks. There are financial and reputational risks for the LGA from continuing to participate in this programme. They are derived from the project risks outlined above.
- 25.1. Financial.
- 25.1.1. The LGA would lose its investment if insufficient operating capital was raised, preventing the launch of the Agency. By the end of mobilisation, this could total £650,000. An early decision to stop the project if this was becoming a reality could reduce the LGA's overall exposure.
- 25.1.2. If the PWLB lowered its interest rates to make the Agency unattractive, or if for any other reason councils decided not to borrow from the Agency and it became unviable, the LGA would also lose its investment.
- 25.2. Reputational.
- 25.2.1. The LGA has a significant reputational stake in the Agency, not least through *Rewiring Public Services*. If the Agency fails to get off the ground, there is a risk that the press and the government, and possibly some member councils, could question the prudence of investing over half a million pounds into such a project, when the PWLB, it could be argued, already offers a reliable and cost effective source of capital borrowing. The public interest case in the revised business case makes a strong case for establishing the Agency and would be a source of rebuttal to such accusations.
26. While the level of council support for the Agency remains steady, councils have yet to be asked to make a financial commitment. At present it is difficult to assess the likelihood of councils being able and willing to invest sufficient capital to cover launch and early years operating costs. As an illustration, it would need 200 councils to invest £50,000 each, or 40 to invest £250,000. In the event, it is extremely probable that many councils will want to contribute less than £50,000, with others happy to invest a larger sum. To mitigate the risk, the LGA will do all it can to promote the benefits of the Agency based on the positive revised business case. It could also set an example by, as recommended, extending its investment in the start-up. As mentioned above, if at any point it became apparent that risks were becoming unsustainable, it would be possible to halt expenditure and return to the Board for a further decision.
27. The full £8 million to £10 million of operating capital will not be required at the beginning of the project and therefore in theory the Agency could be launched without the full amount identified or committed. Continuing investment would then be sought based on the Agency's predicted cash flow up to the break-even point. The risk with this strategy is that if the required capital is not forthcoming the Agency may have to cease trading. In the worst case, this might not arise until after the Agency had burnt through perhaps three years of capital, leading to shareholders losing their investments. There would be a reputational issue for the sector if this was to occur. The risk from taking this approach is considered too large and it is therefore not recommended.

Next steps

28. Further early work will be undertaken to promote the Agency and to raise the investment needed to proceed with implementation, in the first instance seeking the funding to match the LGA's contribution to mobilisation.

29. Recruitment of an interim project team of three to four people to undertake the mobilisation work pending the recruitment of permanent Agency staff.
30. Drawing up the shareholder agreements and negotiating with other shareholders the LGA's shareholding and ongoing role in the Agency.
31. Commence the mobilisation phase summarised above and described in more detail in the revised business case.

Financial Implications

32. It is intended to set up a special projects line in the budget for next year, which amongst other things would cover the approved expenditure on the Agency.