Finance Panel

28 March 2014

Municipal Bonds Agency - Summary of Business Case Review

Public interest case

1. Councils source 75 per cent of their borrowing from the Public Works Loans Board (PWLB). That leaves councils vulnerable to interest rates set to deliver the government's public borrowing plans. The Municipal Bonds Agency would give councils greater control of interest rates and introduce competition and diversity to the marketplace. The Agency could also offer lower penalties for early repayment of loans.

2. Nordic experience 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.

3. The experience of the Nordic Agencies has also shown that the Agency could pass onto councils the benefit of its research into public sector financing. From this expertise it would be possible to develop advisory and tailored lending services and potentially facilitate intra authority lending.

Local Authority and investor demand

4. Councils will have new borrowing requirements for their capital programmes. Our survey identified a borrowing requirement of £5 billion over the next three years from just 46 councils, with 43 expressing an interest in using the Agency. The outstanding stock of PWLB debt matures at £1.7 billion a year. Much of that will require refinancing. Borrowing from banks is forecast to become increasingly expensive. It is estimated that annual local authority borrowing over the next three years will be between £3billion and £5 billion.

5. Banks have indicated a likely significant investor demand for the Agency's bonds. At the same price as Transport for London (TfL)'s double-A rated bonds, council borrowers would save around five basis points (bps) against the PWLB certainty rate (80bps). To achieve better bond pricing, the Agency would need an AAA/sovereign like rating. That could be achievable by holding risk capital between three and five per cent; holding adequate liquidity; providing a joint and several guarantee from borrowers; and ensuring a diverse portfolio of borrowers. An AAA/sovereign like rating combined with a joint and several guarantee should deliver significant savings to borrowers.

6. Because the Agency will be new to the market, it is likely to need to pay a new issue premium in the first one to two years. This will affect the level of savings available to early borrowers. The savings in the previous paragraph will also depend on being able to issue bonds in benchmark sizes of between £250 million to £300 million; otherwise investors will demand a premium for illiquidity.

Joint and several guarantee

7. 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 a joint and several guarantee could expect to reduce the Agency's borrowing costs by 20 to 25 bps, saving £6.2 million to £7.5 million over the life of a 30 year £100million loan. The risks of offering a joint and several guarantee are mitigated by:

    - Security over borrowing and the High court process
    - Proportionality/right of recourse
    - The risk capital and liquidity of the Agency
    - The Agency's credit processes
    - Statutory and budgetary controls in councils
    - The prudential code and minimum revenue provision
    - The statutory responsibilities of Finance Directors (section 151 officers)
    - Access to the PWLB
    - Government reserve powers.

Operating model and capital structure

8. The Agency should issue two bonds in its first year with approximately 30 to 40 borrowers. For the initial issues, council borrowing will need to match the bonds' maturity profiles. Agency staffing will start small and grow as the volume of transactions does. Most functions will be outsourced. The Agency is expected to break even by year three after around £2 billion of bond issuance. It is estimated £8 million to £10 million of operating capital will be needed to cover launch and early operating costs and provide a buffer against risks.

9. 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 shareholding structure would have limits on individual level of control and give a fair return to initial shareholders for risk taking. Voting and economic rights should be de-coupled.

10. Risk Capital will be required to support the first loss protection in the event of a borrower default and should be equivalent to three to five per cent of the loans made to councils. It will be raised through a proportion of a loan taken out by a borrower being retained by the Agency.

Timeline

11. The Agency should aim to issue its first bond to match the March/April 2015 peak in council borrowing. A mobilisation phase should start once the decision to proceed is made and last six months. The mobilisation phase will cost approximately £0.8 million and would establish the corporate structure; hire of key personnel; establish the Board; identify the initial list of borrowers and investors in the Agency; design key policies and processes.

Governance

12. Control should rest with the LGA as the project sponsors in mobilisation phase. A project board should oversee execution, with CFO and political groups retaining an advisory role. Once appointed the Board of Directors (BoD) may operate in a shadow capacity until launch. The project board in consultation with the BoD will determine the point at which the project moves into launch.

13. At launch, the BoD will formally take control of the Agency. The BoD will consist of: three members elected by shareholders, one of whom will be the Chair; a debt capital markets expert; a risk management expert; two council finance directors or equivalent. The CEO may be a Director. The initial board will be appointed by the LGA in conjunction with the project board and in consultation with the shareholders.

Risk

14. There are five key risks at this stage the most significant being that it may not be possible to raise the operating capital from councils or related bodies, despite it being an attractive investment. Other risks relate to council demand; market pricing; PWLB lowering its interest rates; and attracting the right calibre of personnel.