Local authority bonds

A local government collective agency

Introduction

Local authority capital spending pays for the roads, houses, schools and leisure facilities that are at the heart of our communities. This investment drives both economic growth and helps local authorities deliver efficiency savings.

In a typical year local authorities in England and Wales borrow around £5 billion to pay for this infrastructure. Most local authority borrowing has traditionally been from the Public Works Loans Board (PWLB). In October 2010 the PWLB increased its interest rate to 1 per cent above the government benchmark 'gilt' rate, whilst the March 2012 budget announced a 0.2 per cent decrease and a possible further reduction, rates will still be above the 2010 levels.

Some local authorities may respond by issuing their own bonds, and are securing independent credit ratings in anticipation of that. Those local authorities are achieving high credit ratings – reflecting the strength and quality of management in our sector.

But not every local authority will want or be able to borrow the amounts that make such bond issues economic. As a result the Local Government Association (LGA) in England and the Welsh LGA have worked together to establish if local authorities can use their buying power to help all local authorities gain access to lower cost borrowing.

We have looked at international examples, and commissioned experts in the City to advise us. We believe that in the long-term an appropriately structured and capitalised local authority-owned collective agency could raise funds from bonds markets, and lend it onto local authorities at competitive rates.

This agency could provide a benchmark for bonds issued by the local authority sector, benefitting those local authorities that choose to raise their own bonds. The agency would also ensure there is diversity of sources of capital funding, reducing council dependence on a single source of funds.

A local authority collective agency is not a new idea. They have existed for decades in other countries, and deliver low cost loans based on their AAA/Aaa credit ratings[1]. Other local authorities, working with their national governments, from France to New Zealand are currently in the process of developing similar agencies.

This is a well managed and highly regulated area. Nothing in our proposals seeks to change the quality of governance. Indeed our proposals should further strengthen incentives for good financial management.

1 'AAA' is the form of rating used by Standard & Poor's and Fitch, while 'Aaa' is used by Moody's.

Our proposals will also not increase levels of local authority borrowing - local authorities decide that in reference to their ability to fund the long-term loan borrowing costs through the ‘prudential code’. This is about local authorities – and taxpayers – getting the best interest rates and not paying unnecessary costs.

Our vision is for a solution developed by local government for local government, we believe an independent agency would deliver this outcome.

Councillor Edward Lord OBE JP

Introduction

The Welsh Local Government Association (WLGA) is pleased to have been involved in this initiative to provide borrowing to Welsh local authorities at a more cost effective rate than the PWLB or the market has provided.

Wales faces a huge challenge as it seeks to maintain and develop its infrastructure and local government needs to invest in its assets to ensure they are fit for purpose to educate our young people, provide care for our older citizens and create an environment for businesses to establish and flourish.

The scarcity of capital from the Welsh Government coupled with its inability to borrow will only increase the need for local authorities to raise their own capital funding. This opportunity is not one that allows local authorities to borrow imprudently but rather to borrow in the most cost effective and efficient way from a source that is designed for the sector by the sector and on that basis I hope you engage fully in the next stage of the process.

John Rae
Director of Resources, WLGA

Local authority bonds

Financial investment by local government for local government

Infrastructure spending supports this country's long-term economic growth. Capital spending is also part of the way local authorities achieve efficiency savings. The Local Government Association (LGA) analysed the benefits of capital spending in its report: 'Funding and planning for Infrastructure' (2010) concluding that:

- every £1 spent on construction leads to an increase in UK GDP of £2.84
- every £1 spent generates a 56 pence return to the exchequer though tax revenue and benefit savings, and
- each £1 million allocated to road maintenance creates or safeguards ten to fifteen jobs and adds £500,000 to the local supply chain.

This report explains out how a council owned collective agency, could provide funds to support some of that capital spending. It explores the benefits of a sector-led approach and highlights some of the barriers that would need to be overcome.

The need for change

On 20 October 2010 the Government announced that the Public Works Loans Board's (PWLB) interest rates for loans to local authorities would be increased from 0.2 per cent to 1 per cent above the gilt rates. This significantly increased the interest cost on loans borrowed by local authorities.

Whilst larger authorities may be able to raise their own bonds, this option is not likely to be open to most authorities (because bond issues are typically over £150 million in size).

The lack of alternative sources of lending leaves local authorities vulnerable to further changes in the PWLB's terms of trade. This was illustrated by the March 2012 Budget, which signalled a proposed 0.2 per cent reduction in PWLB rates and possible further unspecified reductions, but in return for potential increased oversight of council spending, the detail of which remains unclear.

Councils need certainty when managing capital programmes if they are to make effective long-term funding decisions. With six changes in borrowing rules in three years, councils find it harder to make such plans.

The long-term case for a local government led solution is therefore not based solely on a quantitative, loan charge argument, it is a case which is also underpinned by the stability of having a solution which is managed by the sector, for the sector.

An evidence based review

In March 2011 the LGA Executive brought together senior council politicians from England and Wales. This group oversaw the work to establish if it was feasible for councils to establish a collective agency that could raise and on-lend funds to local authorities at a competitive cost.

A second, technical reference group comprising leading local government financial managers and the professional institute (the Chartered Institute of Public Finance and Accountancy, CIPFA) also reviewed proposals to ensure they technically sound and professionally robust.

Work was informed by independent advice commissioned from HSBC, legal firm Clifford Chance LLP and professional services firm Ernst and Young.

Looking outwards

Many examples of agencies already exist and in order to inform the business case international best practice was reviewed, from the Scandinavian agencies that have successfully operated for many years to the recent developments in France and New Zealand.

Each agency is different, but they share several common characteristics. National and local government work as partners and the agency role is focussed on ensuring the credit worthiness of the local government sector. Strong governance arrangements, agreed by all participants ensure prudent long-term decisions.

Robust option appraisal

A series of options were considered using HM Treasury's, 'five case' business model approach. The recommended option was for a council owned collective agency that gains its financial strength from its strong asset base (loans to local authorities) and risk capital placed with it by participating authorities and possibly third parties.

The agency

The proposed agency would raise funds from capital markets at regular intervals and on-lend funds to participating authorities. The agency would be rated by at least two credit rating agencies, and with appropriate capitalisation, subject to a variety of non-financial factors (including the way in which the agency interacts with/sits alongside the PWLB) and governance arrangements. The agency would seek to secure AAA/Aaa rating.

The collective agency does not rely on cross guarantees. This means no participating authority would find itself exposed to potential liabilities beyond its loan obligations and any risk capital it has invested in the collective agency.

The financial analysis carried out as part of the outline business case suggested that in 'normal market conditions', an agency should be able to raise funds to on-lend to participating authorities at rates broadly similar to the proposed PWLB 'certainty' rate. However, the ongoing upheaval in the financial markets makes it impossible to predict when more stable market conditions might return.

Although there is more detailed work to be done on the operations of the agency, it is envisaged it would be overseen by a board of directors. which would include:

- local government – with majority representation as the owners of the agency
- independent members, in particular those with credit, risk management or government backgrounds.

Challenges

There are a range of challenges and risks in establishing an agency.

The March 2012 budget announced a proposed 0.2 per cent reduction in PWLB loans. This means that the Government has matched the likely price that the proposed agency would achieve when more normal market conditions return. However the government has also made clear they will keep the underlying PWLB lending rate, upon which the discount is applied, under review. This means interest rates charged can still be varied at short notice.

The prospect of a further yet lower PWLB rate undermines the financial case for the agency. However the terms under which the possible lower PWLB rate might be available to councils remain unclear. There is a concern that these terms may require councils to submit to external scrutiny of capital spending, potentially undercutting elements of the prudential code. It is not clear if councils would want to participate in such an arrangement.

The business case assumed at least tacit support from government. Such support is critical in order for financial markets and bond investors to have confidence in the proposed agency. Securing and maintaining the necessary government support is a considerable risk as it appears that some parts of central government may be sceptical to the prospect of such an agency being created at this point.

Based on specialist advice from HSBC the business case assumed that the medium term bond markets would revert to a more normal state within a reasonable period, however the difficulties in the Euro area have continued and when markets are likely to return to normal conditions remains uncertain.

The business case assumed local authority borrowing would continue at approximately a similar level to the last few years. In fact over the last two years council borrowing has fallen by four fifths. This may be regarded as a temporary dip driven by multiple economic factors, or it may reflect a longer term trend as public spending is further squeezed.

Benefits

The aim is that a collective agency would deliver borrowing at broadly competitive rates. Being managed by local government, changes in lending policies would be the result of decisions by local government – as opposed to shifting central government policies.

This collective agency should help create a liquid market for local authority bonds. This should benefit those local authorities that decide they want to issue their own bonds.

The collective agency should:

- provide a viable alternative and complimentary funding source to the PWLB
- create a new class of highly rated bonds of likely interest to UK insurance companies and pension funds (including local authority pension funds)
- avoid the expenses of a series of uncoordinated bond issues.

A membership-based collective agency can become part of a sector-led, coordinated approach to funding. The evidence from other collective agencies is that participating authorities will quickly intervene if a member authority appears to be in difficulties.

The collective agency can help promote local government. Other collective agencies work with bond purchasers and participating local authorities to strengthen understanding of the sector by all participants.

How the proposed agency would operate

The intention is that the agency will be a stable and credible counterparty for prospective bond investors. The governance of the agency will reflect the intended culture that is:

- Straight forward. The use of complex or opaque financial instruments will be avoided.
- Transparent. The activities of the agency will be open, the agency will follow modern public sector principles and publish comprehensive management information.
- Collective. The agency will balance the voices of smaller and larger authorities, much as in the way the LGA does at present. Views of other stakeholders will also be considered.
- Efficient. The agency will emphasise value for money, as income is drawn from public funds. Profits will be used to provide returns on the risk capital invested, and otherwise will be retained in the organisation to build its capital base.

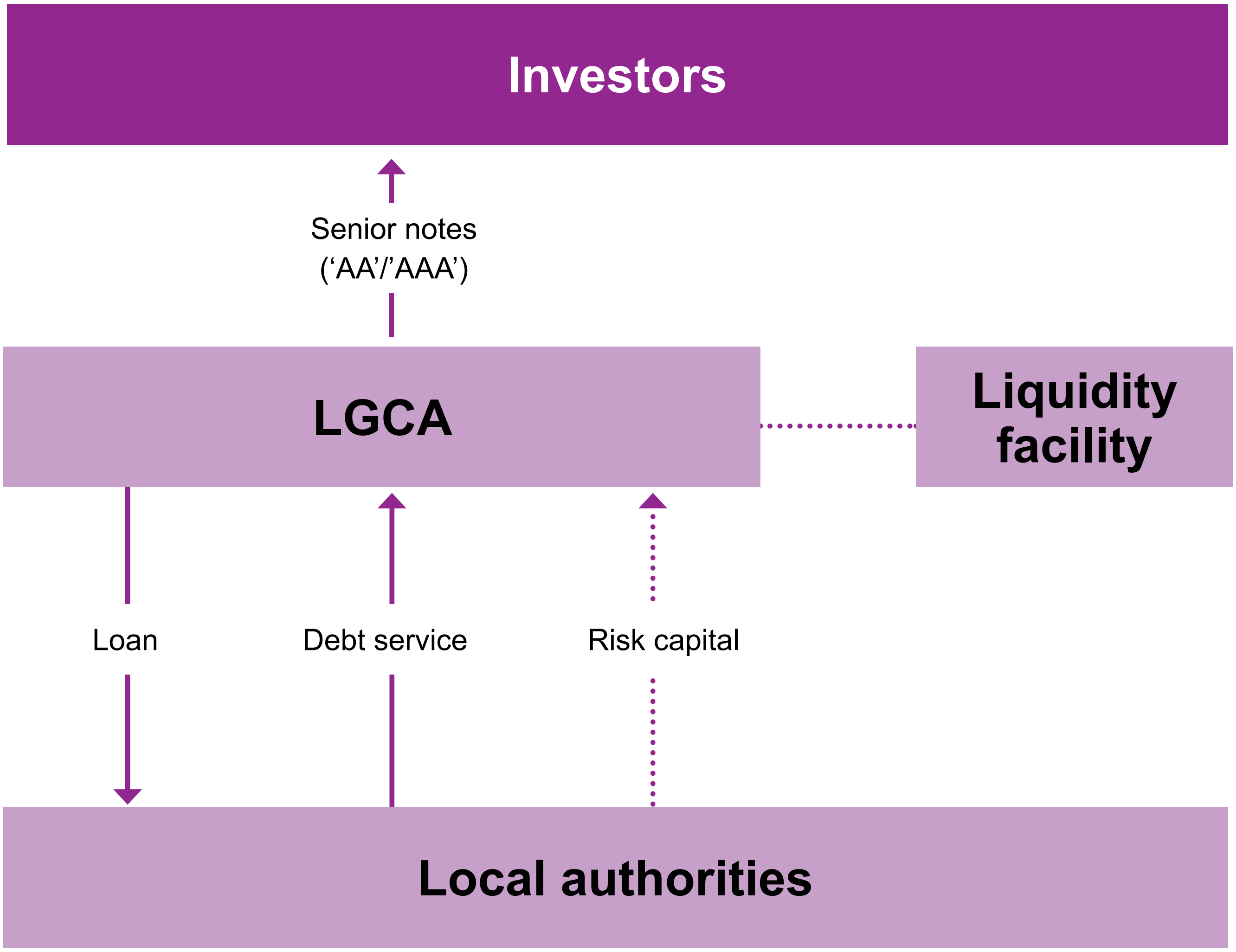
Structure and operating costs of the agency

The issuing entity would probably be a public limited company. Participating authorities or third parties will invest risk capital in the company. Any surpluses generated by the company will be retained within the organisation to:

- increase its capitalisation and (by increasing its financial strength) reduce borrowing costs to participating authorities.
- pay a return on the risk capital
- allow the repayment of the risk capital over time.

The proposed structure is set out below:

Figure 2: Agency structure



Factors that support a AAA/ Aaa rating

Important elements in securing a AAA/Aaa credit rating include strong governance systems, appropriate capitalisation within the wider system of prudential borrowing.

Borrowing funds from the collective agency

The agency will aim to build a presence in the bond markets. In the medium-term the agency would look to develop a programme of regular issues.

The agency will aim to minimise the amount of funding it holds before on-lending. This would mean liaison between participating authorities and the agency as to when those funds are required. In the early years of operation a 'matched funding' approach may be adopted, minimising the risk of the agency holding significant unneeded funds.

The collective agency will require participating authorities to be operating within the prudential code system. However as the collective agency represents all participating authorities and its financial standing is based on their collective reputation, loan funding could not be assumed to be 'on demand'.

Retail bonds

The possibility of accessing the retail bond market has been considered. The London Stock Exchange is developing this market and the intention would be to monitor these developments.

Conclusion

The uncertainty about PWLB interest rates and a potential lack of competition means:

- the sector as a whole is vulnerable to changes to PWLB rates, making long-term capital planning difficult
- smaller local authorities are disadvantaged because they can't easily access the capital markets.

Local authority led collective agencies have successfully operated in a number of countries, in some cases for over a century. In other countries local authorities are currently establishing such agencies with the support of their national governments.

An agency has the potential to be an important part of the sector-led improvement agenda – by strengthening the already strong governance systems in place. Local authority bonds have proved attractive investments for pension funds in those countries that they operate.

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