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UK MUNICIPAL BOND AGENCY

MUNICIPAL BONDS
ROUNDTABLE WRITE-UP

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In March 2015, NLGN hosted a high-level roundtable with senior officers from local authorities, Shadow Chief Secretary to the Treasury Chris Leslie MP* and representatives from the UK Municipal Bonds Agency (UKMBA), to discuss the creation of this, the first agency of its kind in the UK. The discussion considered both the benefits of the agency and the merits of getting more local authorities to invest in municipal bonds. This paper outlines the key themes coming out of these discussions and next steps for driving change across local authorities and rolling out further investment in the UKMBA.

CONTEXT

Local authorities are undergoing a period of rapid financial change. Alongside the implementation of huge reductions to revenue spending, the Coalition government gave more control to councils over the ways in which they finance capital spending, enabling authorities to invest in buildings and equipment to support the delivery of local services. This system gives councils the freedoms to raise finance for capital investment without consent from central government on the proviso that they can afford to service their debt from their revenue resources.[1]

* A the time of publication Chris Leslie MP, is now Shadow Chancellor of the Exchequer

1 https://www.gov.uk/government/policies/giving-local-authorities-more-control-over-how-they-spend-public-money-in-their-area--2/supporting-pages/investment-in-local-government-capital-assets

Despite these new freedoms, the National Audit Office published figures demonstrating that publicly-funded capital investment by councils decreased by a third between 2009/10 and 2013/14.[2] In the current financial climate and in the context of substantial cuts to revenue budgets and the resulting cuts to services, it can be difficult for councils to defend capital investment. Given that resources have to be set aside on a yearly basis to repay the interest on all outstanding loans, taking on additional capital spending can have a direct impact on revenue budgets, which are already under immense pressure to maintain as far as possible current levels of delivery in public services. In this context it can be a challenge to justify to members and citizens additional capital spending, which may come at the expense of ongoing service delivery.

Yet, there is a strong financial and social case for capital investment in infrastructure for communities and a long history of under-investment. Investment can drive local economic growth and pump prime service transformation for long-term gains in both financial terms and outcomes for citizens. In order to accelerate local economic growth, it becomes imperative for councils to create a strong business case for capital spending and find a politically acceptable way in which to fund this investment.

2 http://www.ft.com/cms/s/0/5652c79c-ccae-11e4-b94f-00144feab7de.html

This all comes at a time of rapidly accelerating devolution. The comprehensive deal made in Greater Manchester has opened the floodgates to devolution of power and services, influencing further devolution to – for example - West Yorkshire and Sheffield. While fiscal devolution continues to lag behind, this is the logical next step in an area with considerable existing momentum.

UK MUNICIPAL BONDS AGENCY

The UK Municipal Bonds Agency (UKMBA) offers local authorities a new method of capital finance borrowing as an alternative to borrowing from the Public Works Loan Board (PWLB). It is anticipated that the first bonds will be issued shortly after the 2015 General Election. The aim of the Agency is to reduce financing costs for councils by arranging lending at competitive interest rates. Using municipal bonds, local authorities will be able both to borrow and refinance debts for capital investment independently of the PWLB.
The benefit of the agency is that it provides councils with access to cheaper lending rates while also giving enhanced levels of financial autonomy from the Treasury. Other benefits of the bonds include:

- Reducing the impact of shifting government lending policies, by increasing diversity and competitiveness of lending sources;
- Potentially creating new mechanisms for prudent investment by pension funds in local government infrastructure;
- Increasing transparency and borrowing:[3]
- Providing local authorities with opportunities to access European Investment Bank funding;
- Creating the conditions for London to become the main financial centre for trading in municipal debt.

There are three ways in which the UKMBA will fund lending:

- 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 or insurance companies.[4]

Borrowing from the agency would establish a joint and several guarantee between all local authority borrowers; a collective guarantee agreement of debts between borrowers within the agency. Through this joint and several guarantee, councils would reduce their borrowing costs by 20 to 25 basis points in comparison with the PWLB. Shareholders would only be a part of the joint and several guarantee if they were also borrowers. Incentivising borrowers through such a mechanism is a balancing act: the guarantee is attractive because it strengthens the credit

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3 See: http://www.local.gov.uk/finance/-/journal_content/56/10180/3684139/ARTICLE (accessed March 2015).
4 http://www.local.gov.uk/documents/10180/11531/Municipal+Bonds+Agency+QA+Jun+14+-+final.pdf/8ec7febc-eefb-449c-9dde-10e60f9bfb17

rating of borrowers and thus drives down the price of bonds, but there are also potential financial and legal implications for borrowers if the guarantee has to be called in. Although it would be possible for local authorities to borrow from the UKMBA without also investing in the agency, this would be at slightly higher rates than for those who choose to be shareholders, providing an incentive for more councils to become investors in the scheme.

The ultimate objective for the agency is to involve as many local authorities as possible. This will fundamentally change the way councils borrow and are financed making it considerably cheaper and more efficient. As one delegate at the roundtable put it: “there’s safety in numbers”. At the time of the roundtable, over 50 local authorities had signed up to be investors in the bonds agency.

For local authorities, this creates great potential for transformative change in the way that capital is financed along with greater freedoms and an increased ability to invest for local economic growth. The creation of a municipal bonds market will facilitate greater fiscal autonomy for local authorities and, ultimately, create optimal conditions for further devolution of power and finance to local government.

SPEAKERS THOUGHTS

CHRIS LESLIE MP

SHADOW CHIEF SECRETARY TO THE TREASURY

Chris Leslie MP spoke at the roundtable about the possibilities for local government finance with the creation of the UKMBA. From a political perspective, he noted that very little attention is paid to how local government capital is financed in the House of Commons yet the political landscape will always encourage the development of new infrastructure. For central government to support reforms to the way local government is financed, the ultimate driving force will be ensuring the greatest savings to the taxpayer. For the local authorities involved, the ultimate driving force is price and efficiency.

Leslie noted that it was healthy for local authorities to have more ownership and involvement in capital finance, rather than relying solely on the PWLB, the Treasury and the taxpayer. He suggested that this matures the sector and improves their skills base. A competitive process in the marketplace in this context was heralded as a positive outcome: to drive efficiencies in capital investment and local economic growth through diversification of the market.

Furthermore, developing a successful bonds market and alternative methods of borrowing can create the conditions towards greater

devolution within the UK. Being able to control their own finances is a move in the right direction for local authorities seeking central government authorisation for future self-autonomy.

At present, there are many national restraints on borrowing. Leslie welcomed the UKMBA as a way to develop and advance the market for local authority capital finance.

ENCOURAGING OPT-IN FROM LOCAL AUTHORITIES

Many delegates at the roundtable discussion were from local authorities who had already signed up as investors in the UKMBA and were therefore optimistic about the opportunities that a municipal bonds market could offer. The discussion examined the benefits and drawbacks of the newly-established UKMBA, as well as how to encourage more local authorities to participate.

MAKING THE BUSINESS CASE STACK UP

Delegates from local authorities reported that price will be the most important factor in deciding whether to borrow from or invest in the UKMBA. Any new vehicle for borrowing needed to stack up in business case terms in order that councils might be able to assess the merits of participation. This business case was not merely about the up-front price or interest rates, but also about a council's realistic ability to repay their debt.

Risk sharing and guaranteeing other councils' debts represented a potentially significant psychological hurdle for some local authorities in deciding whether to participate as investors or shareholders. For one council, a delegate suggested that there were internal struggles to reconcile the risks associated, as the costs of servicing their debt – if they were to refinance from the PWLB to municipal bonds – would be equal to the costs of running their fire and rescue service. In this context, gaining consensus across the authority to invest or borrow was a significant challenge. In encouraging local authorities to participate, it was essential that the politics - both party political and internal - of investing in infrastructure were taken into account.

For many local authorities, securing greater financial autonomy from central government was a highly attractive proposition. This will allow them to develop a more sustainable and responsible financial position devoid of the current 'parent-child relationship' which some local authorities perceive as inherent in the current model. This was particularly the case in creating the conditions for fiscal devolution and allowing councils to play a greater role in the economic growth of their areas.

Much of the risk associated with investing was deemed by some as 'perceived' rather than actual. Supportive councils argued that the current economic climate is, in fact, a key driver for getting involved in the agency as an era of fiscal consolidation

could reasonably be viewed to be as much an opportunity to innovate as a reason to exercise caution. There is a strong case to be made about investing in growth as a response to sustained retrenchment in the public finances, where councils and local areas could benefit from business rate growth, higher employment rates and improved standards of living. In this light, it was argued that the risk of joining the bonds agency would be outweighed by the benefits felt by participating councils.

DIVERSIFICATION OF THE MARKET

The creation of a municipal bonds agency will diversify the market, meaning that local authorities will have greater choice and many more avenues to explore in terms of financing their capital and refinancing their debts. With greater choice also comes greater fiscal autonomy for local authorities. By way of comparison, very few private sector businesses would entrust all their borrowing to one lending organisation: there was a compelling case to be made for local authorities to be investing in bonds as part of a diversified, coherent and balanced risk management strategy in the proper interests of their council taxpayers.

At present, the PWLB is responsible for the majority of lending for capital investment. Borrowing from the PWLB incurs fixed interest rates, with a standard rate of 100 basis points – the unit of measure for interest rates defined as one hundredth of one percentage point. Local authorities may pay more favourable, reduced interest rates if they qualify for certainty or project rates: the certainty rate is 80 basis points for local authorities who provide information on their borrowing and associated capital spending, and the project rate is 60 basis points for infrastructure projects nominated by a Local Enterprise Partnership.[5]

For the fiscal year 2012/13, local authority borrowing stood at £84.5 billion, with £63.4 billion of this borrowed from the PWLB.[6] This clearly shows a lack of diversity in borrowing options as councils are overly-dependent on a single source of capital finance through the PWLB and, by extension, the Treasury. This is problematic for a number of reasons, primarily because local authority borrowing is subject to whatever the Treasury is able to offer. Indeed, borrowing interest rates may be subject to change over the course of a day: "[the Debt Management Office] reserves the right to make additional, unscheduled intra-daily rate changes as necessary".[7] A delegate reported that the PWLB had changed repayment terms halfway through a loan repayment, which had made major structural differences to the local authority's debts and investment balances. Another delegate reported that signing up to UKMBA was

5 http://www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Interest_Rates
6 http://www.local.gov.uk/documents/10180/11531/MBA+Report+Final.pdf/037bbcf0-e7f5-4f06-946e-98e7e824ce49
7 http://www.dmo.gov.uk/index.aspx?page=PWLB/PWLB_Interest_Rates

viewed by their authority as an 'insurance' policy against the uncertainty of the PWLB.

The introduction of a bonds market for capital investment was seen as a 'win-win' situation by the roundtable delegates. Firstly, the bonds market dis-incentivises the Treasury from arbitrarily raising its interest rates as councils will have the option to move their borrowing or refinance through the UKMBA. Conversely, if the creation of the UK bonds market led the PWLB to reduce their interest rates, although it would impact adversely on the UKMBA, local authorities would still save money on their capital investment.

RAISING THE PROFILE OF LOCAL AUTHORITIES

Local authorities are not yet well-established in the bond market and thus have a lack of maturity and confidence when facing the market. It is understood that it may take a long time to establish a strong market portfolio to encourage outside investors to buy in to the scheme, although the fact that many borrowers have achieved very strong credit ratings was regarded as promising. One delegate said that local authorities will be encouraged to become significant borrowers in the bonds market if the price paid for bonds was reduced. This would increase the number of alternatives available for raising capital finance, meaning that local authorities will be able to access organisations like the European Investment Bank more efficiently in the future. Increasing the awareness of municipal organisations in the bond market will not only open up more capital investment opportunities for local authorities in the short-term, but also holds out the potential for local authorities to access more funding in the longer-term.

Delegates reported that outside investors have three priorities when it comes to potential investment: high quality credit, diversity in the market, and liquidity to invest. There is a need for local authorities to prove themselves in these three areas: to prove that they are worthy of being invested in. The joint and several guarantee is vital to raise the borrowing profile of local authorities. The guarantee means that investors do not have to set up systems for every individual local authorities as they come to market, which is especially beneficial for small borrowings

In order for the bond market for local authorities to flourish, it was widely agreed that there needs to be broad opt-in at council level and, following this, there needs to be the trust and faith in the system to persuade external parties to invest. Raising the profile of local authorities as investors and borrowers is crucial for the success of the agency. An advantage of coming fairly 'late to the game' to local authority bonds in the UK is the fact that much learning from abroad, for example Scandinavia, was felt to

influence beneficially the ways in which the UK bonds market operates. Furthermore, there was considerable potential for London to become the main financial centre for trading in municipal debt which would create a significant new financial market for the UK.

CONCLUSIONS

The creation of a municipal bonds market is positive for local government as a whole. In the broader context of accelerating local economic growth and creating the conditions for greater fiscal autonomy, and subsequent devolution, presenting local authorities with an alternative method of funding capital investment other than the PWLB and the Treasury should be welcomed by the sector.

For many local authorities, participation in the bonds market is almost exclusively about price and ensuring the business case stacks up. Diversifying the market and raising the profile of local authorities in the bonds market were also noted as key drivers for local authorities. Reconciling the short and long-term benefits with the associated - or perceived - risks is extremely important to ensure buy-in at all levels within councils. Moving forwards, there was a sense that the agency needs to persuade as many local authorities as possible much more rigorously to take the offer up. The offer is more and more attractive, the more the risk is shared and the partnerships diversified. Neutralising fears around risk sharing and presenting the bonds agency as a genuine alternative to the PWLB, especially in terms of greater fiscal autonomy for local authority capital investment, could reasonably be expected to encourage a far broader range of local authorities to invest in municipal bonds.

To do so could deliver a truly transformative change to the way in which infrastructure and capital is financed in the UK, and the ways in which local authorities control and accelerate local economic growth in their areas. This would deliver benefits to local authorities, their council taxpayers, and to Britain and its ability to invest in its economic recovery.

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