Municipal bonds: What will they mean for the UK?

Localis Roundtable Discussion

LOCALIS

UK MUNICIPAL BOND AGENCY

About Localis

Who we are

Localis is an independent think-tank dedicated to issues related to local government and localism. We carry out innovative research, hold a calendar of events and facilitate a growing network of members to stimulate and challenge the current orthodoxy of the governance of the UK.

Our philosophy

We believe in a greater devolution of power to the local level. Decisions should be made by those most closely affected, and they should be accountable to the people which they serve. Services should be delivered effectively. People should be given a greater choice of services and the means to influence the ways in which these are delivered.

What we do

Localis aims to provide a link between local government and the key figures in business, academia, the third sector, parliament and the media. We aim to influence the debate on localism, providing innovative and fresh thinking on all areas which local government is concerned with. We have a broad events programme, including roundtable discussions, publication launches and an extensive party conference programme.

Find out more

Please either email info@localis.org.uk or call 0207 340 2660 and we will be pleased to tell you more about the range of services which we offer. You can also sign up for updates or register your interest on our website.

Contents

Introduction

In March 2015 a number of council leaders, civil servants, city experts, along with the leadership team of the United Kingdom Municipal Bonds Agency (UKMBA) and the devolution tsar Lord Heseltine, met in Westminster. Hosted by the think-tank Localis, the event sought to address what the UKMBA might mean for local government and the country more widely. This pamphlet outlines the key themes to come out of that discussion.


The Rt Hon Lord Heseltine CH

Lord Heseltine gave the opening address and described how driven he is to improve the financial position of local authorities. He saw the rebirth of provincial England as a big part of the political agenda and improved access to finance crucial in facilitating this. He noted that while there was a significant supply and demand for local government finance, the bridge between the two was missing. Lord Heseltine therefore hoped that developments such as the UKMBA would help to provide this much needed bridge between supply and demand and that if so it couldn't come soon enough.

Why was the UKMBA created?

Sir Merrick Cockell

The spark for the UKMBA arose when Sir Merrick Cockell, in his previous role as chairman of the Local Government Association (LGA), attended a municipal bond agency seminar during a conference. After the conference he met the leaders of Swedish and Danish municipal bonds agencies which both have a very successful record in issuing municipal bonds. He thought it perverse that you could trade Scandinavian municipal bonds in London but not UK municipal bonds.

Kommuninvest

Kommuninvest is a Swedish local government funding agency that was set up in 1986. The scheme aims to help municipal governments in Sweden to raise capital through the issuance of bonds in Europe, Japan and other countries. In 2014 Kommuninvest had a market share of 44 percent of Sweden's local government sector's total borrowing with 272 of the 290 Swedish municipalities as members. The Kommuninvest scheme is rated AAA by both Standard & Poor's and Moody's and by the end of 2013 Kommuninvest's lending had reached $28bn.

Source: Kommuninvest Annual Accounts

After the conference the idea of a establishing a UK municipal bond agency was discussed at the LGA. The discussion concluded that a municipal bonds agency would reduce the financial cost to local government in Britain as well as provide other benefits (some of which are detailed further below). The result was that the LGA started the process for creating a municipal bond agency for the UK.

Local government financing key facts

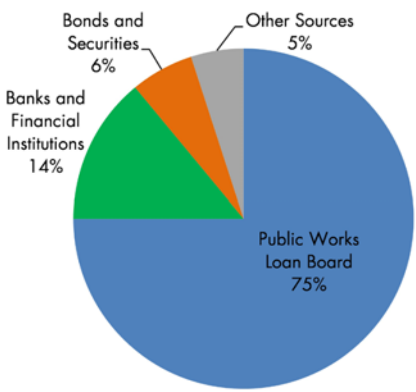
As of 2013 local authority borrowing in the UK amounted to £84.5 billion, of which around 75 percent was from the Public Works Loan Board (PWLB). The UKMBA estimated that the annual potential volume for municipal bonds is somewhere between £3 billion and £5 billion of which they initially expect to capture a quarter market share.

The Public Works Loan Board (PWLB)

Established in 1793 the Public Works Loan Board is a statutory body of the UK Government that provides loans to local authorities. Monies are provided by Act of Parliament and drawn from the National Loans Fund which is HM Government's main borrowing account and is administered by HM Treasury. Nearly all borrowers are local authorities requiring loans for capital purposes.

Source: Public Works Loan Board Annual Report and Accounts 2013-2014

Sources of Local Authority Long Term Borrowing:



Source: UKMBA Business Case

What are the financial benefits of the UKMBA for local government?

A council leader asked what financial benefits the UKMBA would provide to local government. The UKMBA answered by saying that the key benefit for local government was in providing borrowers with a collective strength; allowing them to benefit from the economies of scale of large, liquid bond issues. They added that they could also act as an aggregator to allow projects that might otherwise be too small to access cheaper funds. In other words local government would be able to borrow from a wider variety of sources for less.

"Local government would be able to borrow from a wider variety of sources for less"

The council leaders in attendance were in agreement that at the very least any competition in their lending market would be welcome as the PWLB is effectively the only main lender. They also hoped that the UKMBA would bring more attention to local authorities from the private sector and provide the architecture for a variety of different types of investment. It was hoped by the council leaders that this would drive down the costs of borrwing and increase competition in the sector.

Joint and Several Guarantee

With a Joint and Several Guarantee from the UKMBA, Local Authorities should have a reasonable expectation that they could reduce their borrowing costs by 20 to 25 basis points, versus the PWLB. On a £100m loan, this equates to savings of £200 to £250 thousand, per annum, or £6 to £7.5 million over the life of a 30 year loan. Critically a Joint and Several Guarantee would be 'within vires' for English councils as per the General Power of Competence created by the Localism Act.

Source: UKMBA Business Case

The UKMBA also suggested two additional benefits for those local authorities who sought to invest in the Agency. Firstly, the UKMBA wants to act as a facilitator for short and long-term inter-local authority borrowing which they estimated would help recycle the approximately £40 billion of short term assets held by the sector.This would lower the sector's aggregate borrowing costs by taking existing third parties out of the picture.

Secondly the UKMBA said that they hoped that the scale that they would provide would make it easier for local authorities to access cheaper sources of finance - for example the European Investment Bank (EIB).

The European Investment Bank (EIB)

Established in 1958 under the Treaty of Rome the EIB is the European Union's non-profit long-term lending institution. In 2014 it leant €77bn to member states - of which €7bn went to the United Kingdom. High profile recent funding projects include Crossrail. The EIB has substantial funds available for the UK however the nature of the scale that the EIB requires for lending makes it difficult (if not impossible) for individual local authorities to access funding.

Source: The European Investment Bank; Crossrail

What are the non-financial benefits of the UKMBA for local government?

Panellists were in agreement that the UKMBA would help many commercially minded local authorities spread their wings and be less financially reliant on central government. A Member of Parliament who attended summed up the key non-financial benefit for local government:

"Localism is a very good word, but localism without any money doesn't mean very much... The UKMBA would give credence to the line that we are giving some real responsibilities to local government to allow them to stand on their own two feet".

"Localism is a very good word, but localism without any money doesn't mean very much"

Through greater scale and reach the UKMBA said that they would give local authorities the opportunity to invest their capital in local priorities - for example in housing or transport infrastructure. The UKMBA argued that UK municipal bonds could be seen as 'social impact bonds' because of their benefit to local communities. Many panellists were quick to draw the comparison of late 19th century municipal investment in sanitation and clean water (such as in Joseph Chamberlain's Birmingham).

One panellist who worked in the financial markets (and who had prior experience of municipal bonds) thought that the UKMBA would be a useful vehicle in overcoming the lack of connection in the public mind between the infrastructure that is delivered and those who have provided it. It was surmised that if a local authority could clearly demonstrate that they have raised the investment locally it would improve the public perception of all partners.

It was thought by many panellists that the current dominant method of funding from the PWLB was opaque and difficult to scrutinise.

However the UKMBA suggested that any local authority borrowing through the Agency would be significantly more transparent and open to scrutiny from peers and the financial markets. The UKMBA pointed to overseas experience that peer pressure had proven most effective in raising local authority creditworthiness through greater transparency. Therefore the UKMBA could offer incentives for local authorities in improving their credit worthiness which in turn would allow them to access funding at lower costs. One council leader suggested that greater transparency in local authority finances would also give citizens greater powers of scrutiny which would inevitably lead to better governance and local authority service provision.

The UKMBA also suggested that as it developed as an organisation it would become a centre of expertise on issues relative to the intersection to local government and financial markets. They told panellists that this would provide benefits for investor local authorities through supporting research in local government finance and by transferring knowledge through regular publications and seminars. This would promote the consideration of issues of primary economic and financial importance to local authorities.

What are the benefits for the City?

> "The UKMBA would be valuable for investors looking for portfolio diversification"

The UKMBA reported that they had met with six of the top 10 leading Sterling syndicate banks prior to the event. The feedback from those meetings was that there was likely to be significant demand from financial markets for UKMBA bonds. According to a panellist from an institutional investor the range of short term and long term offerings from the UKMBA would be valuable for investors looking for portfolio diversification. It was also suggested that a new market for municipal bonds in London could ensure that the City becomes the centre for European municipal bond trading - offering the prospect of further growth and job creation.

What are the benefits for the rest of the country?

All those in attendance agreed that the question of how the UK would fund its infrastructure needs going forward was of fundamental importance. Currently local or national infrastructure projects in the UK are funded primarily by central government grants or by investors from outside the country, but attendees suggested that each of these sources was suboptimal, and bemoaned the fact that local authority pension schemes are frequently not invited to bid on infrastructure projects. Projects to be funded by central government - no matter how urgent they are widely agreed to be - are always at risk of blockages and delays due to political manoeuvrings. And while foreign investment avoids some of those risks, it is not ideal for UK PLC to have the profits arising from UK infrastructure creation going abroad.

However attendees were excited by the possibilities offered by the UKMBA in addressing both these issues. The UKMBA will provide a source of funding for infrastructure projects that, while independent of central government, is UK based and so more likely to source funding from UK sources. One of those sources would be from UK local government itself, whose capital could be invested via UKMBA. The result would be a win-win with the broader economic benefits of new infrastructure flowing to the country, while investment returns are used to improve local areas and services - especially relevant in a time of shrinking local government grants.

“The result would be a win-win with the broader economic benefits of new infra-structure flowing to the country”

What are the risks?

A panellist asked 'what is to stop local government going out of control in its borrowing?' Representatives from the UKMBA and the civil service answered saying that all local government borrowing must conform to the Prudential Borrowing Code. In addition to this panellists argued that the Treasury already has all the powers that it needs to stop local government borrowing going out of control and that they monitor local government borrowing extremely carefully given the impact on total public sector debt.

"What is to stop local government going out of control in its borrowing?"

The Prudential Borrowing Code

The 'Prudential Borrowing Code' limits local authorities' borrowing by forcing local authorities to consider whether borrowing is affordable and financially sustainable. For example, authorities must consider the effect of borrowing costs on its revenue budget, HRA rents and Council Tax. The Code has been developed by the Chartered Institute for Public Finance and Accounting and has statutory underpinnings through the Local Government Act 2003 and the Capital Finance Regulations.

Source: Her Majesty's Treasury

What stage is it at now?

The UKMBA has raised capital to go live solely from local authorities, with 56 councils either as shareholders, or committing to become shareholders. This covers just over 30 percent of the population of England. Shareholders come from the smallest districts to the largest cities, from all parts of the country and from all political control.

Phase 1: Making a Business Case

October 2010	The PWLB began charging a margin over Gilts of 100 basis points on all loans
January 2012	In response to the PWLB charging a margin the LGA publish an outline business case for a local government collective agency that issues local authority bonds
November 2012	The PWLB reduced its rate to 80 basis points above Gilts for local authorities which could not supply details of funding requirements (98% of advances fall into this category)
Q4 2013	The LGA review the viability of a local government collective agency and re-establish the project now known as the UKMBA

Phase 2: The creation of the UKMBA

January 2014	The UKMBA appoint a leadership team
Q3 2014	The UKMBA's corporate structure and Phase 1 capitalisation is completed
Q4 2014 - Q2 2015	Detailed bond structuring, Phase 2 capitalisation and preliminary rating completed
Q3 2015 >	Financing operations to commence

What happens next?

The UKMBA expect a programme of debt issuance intended, in benchmark £250 to 300m sizes, to start from Summer / Autumn 2015. With the strength of central government behind the sector and Joint Several Guarantees, the UKMBA should get funding at a very competitive level - and at a cheaper rate than is currently offered by the Public Works Loan Board.

While the UKMBA expect funding costs to drop over time and that initial issuances would be all of the same maturity, they suggested that this was not proving any kind of barrier for the shareholder local authorities they had talked to. Indeed the UKMBA said that the local authorities were “completely sympathetic with the approach that we’re adopting and whilst initial borrowers may pay more than borrowers to the agency in five years’ time, we suspect that those initial borrowers will also be the borrowers in five years’ time.”

When asked about the future local authority appetite for the Agency, the UKMBA outlined three areas they thought would be of interest. First would be in refinancing PWLB debt. They estimated - based on PWLB loan maturity - that £1.7 billion of local authority borrowing would need to be repaid or refinanced annually. Second would be refinancing bank debt as it accounts for over £7 billion of current local authority borrowing. If bank margins increase then lending might have to be refinanced. Thirdly would be new debt which could be required as demographic trends are expected to put further pressure on local authorities to invest in highways, infrastructure projects and housebuilding.

Ultimately the UKMBA have the ambition of getting all local authorities in the UK to become involved as members. They view having 56 authorities, along with the Local Government Association, as a very powerful start on that journey.

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