Report of the Director
of Policy & Resources

Decision to be implemented
with immediate effect –
16 July 2014

NORTH LINCOLNSHIRE COUNCIL

POLICY AND RESOURCES CABINET MEMBER

LOCAL GOVERNMENT AUTHORITY BONDS

1. OBJECT AND KEY POINTS IN THIS REPORT

1.1 To outline the Local Government Associations proposal to establish a 'Municipal Bond Agency' and the benefits this may offer the council

1.2 To consider the benefits and risks of the council becoming a 'Founder Investor' in the fund

1.3 This decision is urgent because the Bond Agency requires a letter of intent from each investor by noon on the 17 July 2014. Without this decision the letter cannot be sent and the full benefits of membership cannot be realised.

2. BACKGROUND INFORMATION

2.1 In September 2013 the Local Government Association (LGA) Executive outlined a project plan to establish a collective Municipal Bond Agency (MBA), which would raise funds from capital markets at regular intervals and use this capital to lend to participating authorities. This is a key strand in the LGA's *Rewiring Public Services* paper which set out the changes it believes are needed at both local and national levels so that public services can help communities to meet people's future needs and aspirations. One aspect of this was a proposal to boost investment in infrastructure by creating a thriving market in municipal bonds.

2.2 Currently 75% of councils borrowing is sourced through the Public Works Loans Board (PWLB), over 95% for North Lincolnshire Council, which offers money at the rate of Treasury Gilts plus an additional percentage set by the Chancellor (currently 1%). A discount of 20 basis points (0.2%) is then available for local authorities qualifying for the Governments Certainty Rate. The LGA believes an MBA would allow local authorities to borrow at rates significantly below that offered by the PWLB and that there is a strong public interest case for this:-

- Councils are vulnerable to interest rates set by Governments borrowing plans and an MBA would give councils greater control of interest rates and introduce competition to the marketplace
- An MBA could offer lower penalties for early repayment of loans.
- An MBA would create a potential new mechanism for prudent investment by pension funds in local government infrastructure
- It would create a centre of excellence between capital markets and local government finance.

2.3 The LGA produced an outline business case in January 2012 which following revitalised interest has now been updated and a revised business case published on 20th March 2014.

2.4 The LGA Business case envisages that the establishment of an MBA could reduce local authority financing costs by 20 (0.20%) to 25 (0.25%) basis points. It intends that this will be achieved by the Agency raising capital on the financial markets through the sale of bonds and lend the proceeds to eligible councils at a lower rate than the PWLB or than if councils were to issue their own bonds. The lower rate will be attained by;

- Achieving a AAA/sovereign-like credit rating through a joint and several guarantee, this involves borrowers not only guaranteeing their own borrowing but collectively guaranteeing the obligations of fellow borrowers.
- Issuing bonds in benchmark sizes of £250m to £300m

2.5 It is intended that the Agency would pass on to local authority borrowers the benefits of any reduction in borrowing costs, after covering transaction costs, with a margin being paid to the Agency.

2.6 To progress this process the LGA have set up a Shell Company (Local Capital Finance Company LTD) which is a non-trading private limited company which is to be used for raising funds before starting operations. This is part of a phased process to introduce the MBA:

Phase 1, Mobilisation Phase

- Establishing the corporate structure and raising the required level of capital,
- Identifying the initial set of local authority borrowers,
- Commencing the selection of 3rd party suppliers / outsource arrangements
- Commencing hiring of permanent staff, and
- Completing drafting of Policy, Procedures and Process manuals.

Phase 2 Launch Phase

- Permanent staff have been recruited and commitments entered into;
- Loans to local authorities have been committed, potentially subject to conditions;
- Syndicate banks, legal advisors and ratings agencies etc. for bond issuance selected; and

- 3rd party outsourcing / servicing arrangements implemented.

2.7 The LGA have now moved to progress Phase 1 and have so far approached around 90 councils with a view to them becoming founder investors.

3. OPTIONS FOR CONSIDERATION

Capital Investment

3.1 The Chief Executive has recently received a memorandum from Michael Lockwood the Director of the Local Capital Finance Company Limited seeking support for the establishment of the MBA and asking for consideration to be given to the Council becoming a founder investors.

3.2 The Company is seeking to raise up to £10m of equity capital in two phases. This is in order to fund the launch phase of the Company through to breakeven.

3.3 In Phase 1 the company is seeking to raise a minimum of £900k of capital, £500k being committed by the LGA and at least £400k being committed by UK local authorities or UK local authority pension funds. It has been announced that £2.9m has been committed by 22 councils as at 9th July 2014.

3.4 In Phase 2 they will seek to complete the capital raise of up to £10m, with the volume of shares at this stage being dependant on the commitment in phase 1. Phase 2 funding raising is anticipated to be completed by the end of the final quarter of 2014. At the end of Phase 2 fund raising the Company will issue bonus shares to each investor who purchased in Phase 1 to ensure the aggregate price of each Phase 1 share is one-third lower than the price of a share purchased in Phase 2. It remains at the investors discretion should they wish to split their investment between Phase 1 & 2.

3.5 Around half of the councils approach have expressed an interest in becoming founder investors. The minimum investment is £10k in phase 1 and there is no upper limit to an individual investment within the £10m capital limit. The LGA has suggested different levels of investment that might be considered by different sized authorities;

Smaller Authorities	£10,000 to £50,000
Medium Sized Authorities	£50,000 to £150,000
Larger Authorities	£200,000 to £300,000

Share Holders Right

3.6 The share capital of the Company will be divided into two equal classes of share LGA and Investors shares. The LGA shares will carry a minimum of 75% voting rights regardless of capital raised in Phase 1, this being in order to maintain control over the execution of the business plan. Upon completion of Phase 2 fundraising it is intended that the LGA shares will have an equal footing with investors shares with the exception of certain veto rights, principally designed to ensure the Company remains committed to its original philosophy. Individual shareholders rights will be capped regardless of the volume of shares held. This is to ensure the broadest level of accountability and engagement.

3.7 All shares shall have equal economic rights including with regard to entitlement to dividends. Should the Company be wound up for any reason remaining assets would be distributed proportionally up to the level of the cash investment. Any surplus assets would be distributed proportionally.

3.8 Shareholders will be entitled to transfer shares to other local authority investors post completion of Phase 2 and may trade at any agreed price between parties. It is possible that the Company may make a shareholding a precondition for borrowing from the Company and should that event arise existing shareholders would be given the opportunity to transfer shares. Other than this the transfer of shares will be subject to approval by the board of Directors or subcommittee.

Governance

3.9 The company will be controlled by the LGA during the setup phase. Control will pass to a Board of Directors when the agency is launched.

Risk

3.10 There are five key risks to the agency at the moment. The most significant being that the agency may not be able to raise all the capital it requires. However the initial target of obtaining funding commitments of £400k by the 17th July 2014 had been exceeded by £2.5m. The other risks relate to council demand for lending, market pricing, the PWLB lowering its rates making the agency less attractive and attracting the right calibre of employee.

3.11 The joint and several guarantee the Agency requires will increase the risk to the council, which otherwise would have been capped at the level of its investment. However the risk of councils defaulting on repayment is considered small.

4. ANALYSIS OF OPTIONS

4.1 There are two options available to invest in the MBA or not to invest.

4.2 The potential benefits of investing in the MBA are significant. A reduction in interest rates of 20 basis points (0.2%), the lower end of the MBA's forecast, would save £50k on a £1m loan over 25 years. The equivalent saving when discounted back to today's value, the savings net present value (NPV), would be £24k. The current capital programme assumes £17.7m of borrowing in 2014/15. The saving on this level of borrowing would be £35k per annum with a total saving of £880k over 25 years with a net present value of £420k.

4.3 There are risks to investing in the MBA. The risk of the body failing to reach its investment target has reduced since the MBA has received commitments to invest of £2.9m. This is well in excess of its target to achieve £400k at this point and is over a quarter of the £10m total it is seeking to raise. The council's liability, should the MBA fail assuming joint and several liability, would be the loss of its shareholding and a share of any net liabilities of the agency when it was wound up. Previous experience of similar winding up exercises suggests that it is likely to take years to complete but could result in at least a partial recovery.

4.4 The council would also be exposed to the risk of the Agency's share price fluctuating. This risk would be limited to the amount invested. There may also be a potential market for shares in the MBA if, as predicted, being a shareholder is a prerequisite to being able to access lending. It is also possible that in future the MBA would be able to issue dividends.

5. RESOURCE IMPLICATIONS (FINANCIAL, STAFFING, PROPERTY, IT)

5.1 The suggested level of investment for an Authority of the size of North Lincolnshire Council is £50,000. A lower investment of £20,000 would still allow access to future lending from the MBA and would reduce the potential risks and to a lesser extent benefits.

5.2 An investment of this kind would be capital spend under the capital financing regulations. An investment would therefore need to be established as a scheme in the capital programme. The financing of the scheme would be from internal borrowing.

6. OUTCOMES OF INTEGRATED IMPACT ASSESSMENT (IF APPLICABLE)

6.1 N/A.

7. OUTCOMES OF CONSULTATION AND CONFLICTS OF INTERESTS DECLARED

7.1 No consultation has been undertaken.

8. RECOMMENDATIONS

8.1 That the cabinet member approves an investment of £50,000 in the Phase 1 of the Municipal Bond Agency funding process.

8.2 That the cabinet member approves the inclusion of this investment in the capital programme.

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Background Papers used in the preparation of this report - None