South Cambridgeshire District Council

Report To: Leader and Cabinet 10 July 2014
Lead Officer: Executive Director

Subscription to the Local Government Association's Bonds Agency

Purpose

1. To consider if the Council should participate in the Local Government Association's Bond Agency as a founder member and, if so, at what level should it invest in the initial fund raising.

2. This is not a key decision but it has been brought before Cabinet as it requires a financial contribution for which there is no provision and it was first published in the May 2014 Forward Plan.

Recommendations

3. It is recommended that Cabinet:

   (a) Approves the investment of up to £50,000 in shares in the Local Government Association's Bonds Agency, and
   (b) Delegates the final decision on investment to the Executive Director in consultation with the Leader.

Reasons for Recommendations

4. It is anticipated that the creation of a Bonds Agency, controlled and owned by local authorities, will reduce the debt financing costs for its borrowing members and provide a collective investment vehicle that would secure good returns for its investing members whilst minimising risk.

5. The new agency will require funds in the initial stage to cover set up costs and subsequently to provide adequate working capital once in operation. The fund raising will be carried out through the issue of shares offered to all local authorities. It is anticipated that, once in operation, the Agency will be able to pay a dividend to its shareholders commensurate with the level of risk and financial commitment.

Background

6. One of the Local Government Association's ten big asks in its Rewiring Public Services campaign is to boost investment in infrastructure by re-creating the thriving market in municipal bonds. With 75 per cent of council long-term borrowing coming from the Public Works Loans Board (PWLB), the hike in PWLB interest rates, to one per cent above gilt the gilt rate, at the end of 2010 led the LGA to start looking at the potential for a Municipal Bonds Agency. An initial outline business case was subsequently published in January 2012.

7. In July 2013 the LGA launched Rewiring Public Services, which led to the revitalisation of the project and the development of a revised business case, which was endorsed by the LGA's Executive Board on 20 March 2014 (the link to full business case is provided under background papers below and the Executive Summary is attached at Appendix 1).

8. The Council's Treasury Management Strategy lists the Agency as an approved investment counter-party. The author of this report has concluded, however, that separate approval for investment in the equity of the Agency should be sought given the specific nature of the investment and the higher risk profile (see below).

Considerations

9. The broad principle of the agency is that it will raise capital on the financial markets through the sale of bonds and on lend the proceeds to eligible councils at a lower rate than the PWLB or than if the councils were to issue their own bonds. This lower rate will be attained by:

   (a) Achieving a AAA / sovereign-like credit rating through a joint and several guarantee (see section 6 of the business case) and adequate risk capital of three to five per cent of the total volume of bonds (see section 4.6.2.8 of the business case).

   (b) Issuing bonds in benchmark sizes of £250 million to £300 million.

10. But the LGA believes there are other important factors for councils to consider beyond price:

   (a) Reducing exposure to shifting government lending policies through increased competition and diversity of lending sources.

   (b) Creation of a potential new mechanism for prudent investment by pension funds in local government infrastructure.

   (c) Increased transparency on borrowing: while the PWLB processes are very efficient, they don't carry the normal level of scrutiny lending large sums of money would entail. Experience in other countries has shown that an Agency's credit processes aligned with the incentive of lower borrowing costs, and the oversight of peers, has strengthened the overall credit worthiness of councils.

   (d) The creation of a centre of expertise at the intersection between capital markets and local government finance.

   (e) Tailored flexibility evolving from the development of the centre of expertise.

11. The proposals are grounded in the prudential code and the revised business case reinforces the principle that borrowing by councils must be prudent and affordable. In developing the revised business case, the LGA team met with six of the top ten leading sterling syndicate banks and the general sense was that there was likely to be significant demand for the Agency's bonds.

12. The revised business case presents a strong financial argument. However, without first securing the investment required to establish the Agency, and, second, finding committed borrowers for the capital raised from the first bond, it won't be possible to proceed.

13. The Agency doesn't just offer the prospect of cheaper borrowing for councils, but also an investment opportunity for both councils and council pension funds. The latter not only have the option of purchasing the bonds, but like councils they can invest in the establishment of the Agency and take an equity stake in it.

14. The initial start-up costs are estimated to be in the region of £900,000 and the LGA has committed £500,000 of its resources towards this. The balance will be raised through a private equity placing of shares at £10,000 per block. The shares will only be offered to relevant organisations principally, local authorities and local authority pension funds. This will be phase 1.

15. Once in operation the agency will require c £10m in working capital to sustain its operations in the first three years of operation after which, even at relatively low levels of bond issuance, the agency should move into profit and will be able to pay a dividend to its shareholders on a recurring basis. As with the initial fund raising this sum will be secured through the sale of further shares to local authorities at £10,000 per block.

16. Once the fund raising is complete, given the riskier nature of the investment, the Agency plans to issue bonus shares to phase 1 investors so that their stake is worth 1.5 times that of investors in phase 2.

Options

17. The Council could decide to participate in the Bonds Agency as a founder member by subscribing to the initial Equity Offering. The minimum subscription is £10,000 and authority is being sought to invest up to £50,000 to this offer.

18. The Council could decide not to participate at this stage but subscribe later at the working capital fund raising stage once the agency has been established or not at all.

Implications

19. In the writing of this report, taking into account financial, legal, staffing, risk management, equality and diversity, climate change, community safety and any other key issues, the following implications have been considered:

Financial

20. No budget provision exists for the share subscription. Cabinet is therefore, invited to use its delegation, under the Constitution, to authorise the expenditure of up to £50,000 without prior approval by Council. It is anticipated that the shares will return a good rate of return through the payment of dividends in due course.

21. The investment will rank as capital expenditure; it is recommended that this is funded from internal borrowing (using cash reserves in lieu of raising loan finance) initially. The revenue cost of this proposal is minimal (the interest foregone would be circa £300 a year at current interest rates). Should the investment reduce in value however, (see risks below) this would crystallise a charge to the General Fund of up to £50,000. It is anticipated that these sums can be found from the Treasury Management Account from higher than budgeted interest receipts. This arises from the announcements from the Governor of the Bank of England over the last month in which he signalled earlier increases in bank base rates than assumed in the Council's Treasury Strategy.

Legal

22. The LGA have undertaken extensive reviews of the vires of local authorities to participate in the Agency and to raise funding in the manner proposed. This advice, concludes that English local authorities have all of the relevant powers under the General Power of Competence created by the Localism Act. The Council's Head of Legal and Democratic Services has reviewed this advice and has not identified any impediments to the Council acting as proposed in this report.

Risk Management

23. There are a number of risks that crystallise from participating in the share offering that could have the effect of reducing or nullifying the value of any investment made by the Council at this stage:

(a) As with all start ups, that the business model cannot be developed as envisaged.

(b) The Agency is unable to secure the working capital requirement

(c) The anticipated demand from local authorities does not materialise (see consultation section below)

(d) The Agency is not able to secure bond placements at the prices (interest rates) anticipated

(e) The Government may decide to reduce the margin it levies on PWLB loans so reducing the attractiveness of the Agency as a fund raising vehicle

(f) The Agency may not attract staff of the required calibre or at a cost higher than anticipated.

24. It is important to note, however, that participating as a shareholder will not impose a joint and several liability on the Council to guarantee bonds issued. This will only be imposed on Councils participating in an individual bond issuance and it is noted that there are significant protections under English Law for guarantors in these circumstances in any case.

Consultation responses (including from the Youth Council)

25. The LGA have undertaken extensive consultation with their member authorities and have identified a demand for the Agency including identifying the likely scale of bond issuance of the next 3-5 years.

26. The author of this report has not conducted any consultation with external local stakeholders on this matter. The principles of the Agency were covered in the Investment Workshop held for all members in January 2014 and general support for proceeding with the Agency was received.

Effect on Strategic Objectives

27. The Council has identified a number of objectives that may require capital investment utilising prudential borrowing powers over the Corporate Plan period. Participating in the Agency will allow the Council to get access to funding at potentially lower cost than currently available.

28. Participation in the Agency requires and demonstrates a commercial approach to business planning that should generate a return to the Council should the objectives of the Agency be met. The Councils participation in the formation of the Agency will allow it to have a voice and a direct stake in the Agency's success in the future.

Background Papers: Report by the LGA on the business case and operating principles of the Agency: http://www.local.gov.uk/documents/10180/11531/MBA+Report+Final.pdf/037bbcf0-e7f5-4f06-946e-98e7e824ce49

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