TREASURY MANAGEMENT – LOCAL AUTHORITY MUNICIPAL BONDS

Finance and Resources Advisory Committee – 3 June 2014

Report of the:	Chief Finance Officer
Status:	For Consideration
Also considered by:	Cabinet – 17 July 2014
Key Decision:	No

Executive Summary: The only real source of borrowing for small district councils is the Public Works Loan Board (PWLB), which means that there is no alternative to the rates that they offer. The Local Government Association (LGA) is proposing to create a collective Municipal Bonds Agency which it believes would allow councils to raise funds at a significantly lower rate than those offered by the PWLB.

This report seeks Members approval to be part of a scheme to match fund the LGA's contribution to the creation of the Agency.

This report also revisits previous discussions on the use of non UK banks for the placing of investments.

This report supports the Key Aim of Effective Management of Council Resources.

Portfolio Holder	Cllr. Ramsay
Contact Officer	Roy Parsons, Principal Accountant - Ext 7204

Recommendation to Finance and Resources Advisory Committee: That the recommendations to Cabinet be endorsed.

Recommendations to Cabinet:

a) That, subject to the views of the Finance and Resources Advisory Committee, the Council contributes up to £50,000 towards the set up costs and operating capital of the LGA's Municipal Bonds Agency;

b) that authority be delegated to the Chief Finance Officer, in consultation with the Portfolio Holder for Finance and Resources, to agree the final level of contribution; and

c) that investment in non UK banks, having a minimum long term Fitch rating of AA-, is recommenced as detailed in the report.

Reason for recommendations:

a) To ensure that alternative sources of funding are available should the Council decide to borrow in pursuit of its strategy to move towards a more financially self sufficient position as envisaged in the Corporate Plan; and

b) to enable a wider range of investment opportunity with the potential to increase yield.

Introduction and Background

1 The only source of borrowing for small district councils is the Public Works Loan Board (PWLB). This means that we are limited to the rates that the PWLB charge.

2 The Council's Capital Programme is currently financed by a combination of internal funding from earmarked reserves and then from capital receipts. The Council has agreed a programme of asset disposals generating significant capital receipts. However, the delivery of some planned projects will depend on external borrowing.

3 In recent years, the Council has been faced with ongoing reductions in government support and decisions have been taken through the 10 year budget process to try and ensure that the Council remains in a financially sustainable position going forward. The Corporate Plan suggests an approach of investing in assets that will generate revenue income to replace diminishing government support. This might be achieved by a review of the use of reserves or through borrowing at low interest rates.

Rationale for setting up a Municipal Bonds Agency

4 The LGA started looking at this idea in early 2011. In August 2012, they issued their review document, which is reproduced in the Appendix. Further work was then carried out leading to the LGA Executive's decision to launch the Agency in the Autumn of 2014.

5 One of the ten big ideas in the LGA's Rewiring Public Services programme is to 'Boost investment in infrastructure by recreating the thriving market in municipal bonds which England once had and most other countries still have'. Reviving council borrowing directly through the capital markets offers the prospect of cheaper borrowing and a better deal for the council tax payer. It would also free local authorities from Treasury control by ensuring there was an alternative source of funding to the PWLB, and through that route, keep PWLB rates low too. Council bonds would offer investors a direct route to invest in capital projects in a way that government bonds do not (three-quarters of the Treasury's borrowing goes to fund revenue spending). Furthermore, a revived municipal bond market would be a powerful expression of local authorities' commitment to investing in economic growth.

6 The LGA has prepared an outline business case for the establishment of a Municipal Bonds Agency. This assessed that a municipal bonds agency should, in stable bond market conditions, be able to raise funds in the bond market at around 0.5% above the long-term gilt rate and on-lend to participating authorities

at an interest rate of 0.7% to 0.8% above the gilt rate. The near-monopoly PWLB offers money at a rate of Treasury gilts plus an additional percentage set by the Chancellor of the Exchequer. The rate currently sits at a 1% premium to gilts, with discounts available subject to conditions.

7 Modelling work done by the LGA shows that a Municipal Bonds Agency would allow councils to raise funds at a significantly lower rate than those offered by the PWLB. The model shows that a council borrowing £100m over 20 years would stand to save as much as £4.7m compared to a PWLB loan.

8 According to the LGA, in addition to the immediate cost saving, the benefits of establishing a Municipal Bonds Agency would be:

- sustainable lower borrowing costs, free from the risk of the Treasury changing its lending margins in the future
- control by councils of the Agency's lending terms, including the ability to refinance debt without the PWLB's penal repayment clauses
- council ownership of the Agency
- diversity of funding sources, ensuring long term competitive pressure on the PWLB

9 18 councils have already made formal expressions of interest in the creation of the Agency and have committed to working with the LGA do develop it.

10 The LGA has estimated that a budget of up to £1m will be required to set up the Agency. The LGA has already committed £150,000 and proposes to raise that to £500,000, provided £400,000 of it is equally matched by contributions from councils in return for an equity stake in the Agency. Once this so-called 'mobilisation phase' is complete, the Agency will then require an estimated £8-10m of operating capital to cover launch, early operating costs and provide a buffer against risks.

11 While the level of council support for the Agency remains steady, councils have yet to be asked to make a financial commitment. The LGA is now actively seeking investment from councils towards the £1m start up costs. To raise a total of £10m start up costs and operating capital, it would require 200 councils to invest £50,000 each or 40 to invest £250,000.

12 The Council is required to operate a balanced budget, which broadly means that cash raised during the year will meet cash expenditure. Part of the treasury management operation is to ensure that this cash flow is adequately planned, with cash being available when it is needed. Surplus monies are invested in low risk counterparties or instruments commensurate with the Council's low risk appetite, providing adequate liquidity initially before considering investment return. The LGA's proposals are grounded in the local authority Prudential Code, nothing new is being proposed.

13 Members views on the scheme would be appreciated.

Other treasury management issues

14 A representative of Handelsbanken will be giving a presentation to this meeting. Handelsbanken is a Swedish bank that operates in the UK. They will shortly be opening a branch in Sevenoaks town centre. They are keen to enter into a relationship with the Council and they have investment products which would suit the Council's requirements. They are firmly established in the local authority deposits sector.

15 The Council's investment strategy has always allowed for investment in non-UK banks. However, this ceased in the aftermath of the 2008 financial crisis. The issue has been the subject of discussion at previous meetings of this Committee and its predecessor. At present, the preference is to continue to only lend to UK banks and building societies.

16 If Members are minded to lend to Handelsbanken, then the policy of only lending to UK banks and building societies would have to change. At this juncture, it might be prudent to consider lending to other highly rated non UK banks that appear on our treasury advisor's recommended lending list. A minimum long term Fitch rating of AA-, the same as that of Handelsbanken, could be a useful benchmark. This would include banks in countries such as Australia, Canada, Netherlands, Singapore and UAE (amongst others). The duration of the investment would be determined by reference to our treasury advisor's colour-coded matrix. Initially, the lending limit could be set at half that of the UK banks (i.e. £3m per counterparty).

17 It should be noted that only a few of the potential counterparties appear in the market and then only periodically. It might be that none are in the market when we want to invest or their rates may be inferior at that point in time. However, as a means to spread risk, it is a useful option to have.

Key Implications

Financial

18 As part of the Council's aim to become more financially self sufficient, a strategy is being developed to invest in assets to produce a revenue stream. Part of this process might involve borrowing to acquire those assets. The LGA's proposal brings competition to the market to ensure borrowing rates remain as low as possible.

19 The option to invest in non UK banks gives greater scope to place investments and potentially increase yield. It reduces the concentration of investment in a handful of UK banks.

Legal Implications and Risk Assessment Statement

20 The Municipal Bonds Agency is a complex and demanding project, with a number of risks, key of which is a lack of local government support undermining the credibility of the project. This in turn could lead to insufficient funding. The government could also reduce the PWLB interest rates.

21 However, the benefits of having a Local Government Collective Agency are judged to outweigh the risks. It offers councils a potentially cheaper source of capital funding and importantly frees them from the uncertainty of unpredictable government adjustment of PWLB interest rates and the significantly higher repayment burden any increase would imply. Efforts to mitigate the risks will focus on working closely with interested councils, the Government and the Treasury to give them a sound understanding of what the local authorities are trying to do.

22 Under Section 151 of the Local Government Act 1972, the Section 151 Officer has statutory duties in relation to the financial administration and stewardship of the authority, including securing effective arrangements for treasury management.

23 There will be third party costs to establish the agency some of which will need to be spent in advance of launch and will be funded by a mix of contributions from the LGA's own budget and advance payments by councils which would be members of the agency; those advance payments will be converted after launch into subordinated debt securities of the agency. There will be a financial return for these capital subscriptions for establishment costs remunerated at commercial rates of return.

24 Once the Agency was established, this would be converted into subordinated debt securities and shown on the Council's balance sheet, with no impact on the General Fund. The contribution would be made over a period of time on the basis of progress in setting up the Agency.

25 Taking part in the set up of the agency does not commit the Council to borrowing but would give early access to cheaper borrowing if required.

26 Treasury management has two main risks :

- Fluctuations in interest rates can result in a reduction in income from investments; and
- A counterparty to which the Council has lent money fails to repay the loan at the required time.

Consideration of risk is integral in our approach to treasury management.

27 This report suggests expanding the lending list. The movement in previous years towards having a restricted lending list of UK-only institutions but higher individual limits with those institutions has reduced the chances of a default. But if a default did occur, the potential loss would be greater. The proposals in this report do create additional risk.

Equality Impacts

Consideration of impacts under the Public Sector Equality Duty:		
Question	Answer	Explanation / Evidence

Consideration of impacts under the Public Sector Equality Duty:		
Question	Answer	Explanation / Evidence
a. Does the decision being made or recommended through this paper have potential to disadvantage or discriminate against different groups in the community?	No	The recommendation is concerned with investment management and does not directly impact upon a service provided to the community.
b. Does the decision being made or recommended through this paper have the potential to promote equality of opportunity?	No	
c. What steps can be taken to mitigate, reduce, avoid or minimise the impacts identified above?		No mitigating steps are required.

Conclusions

28 The effect of the proposal to widen the lending list, as set out in this report, is to allow the Council to effectively and efficiently manage cash balances.

29 If Members are minded to support the LGA's Municipal Bonds Agency, and it comes to fruition, a wider range of borrowing options will be available at potentially lower rates. This will help reduce the burden on the revenue budget.

Appendix: Local authority bonds – A local government collective agency (LGA, August 2012)

Background Papers: None

Adrian Rowbotham
Chief Finance Officer