Meeting of the Full Council
Meeting to be held on Thursday, 21 July 2016

Report submitted by: Head of Corporate Finance

Part A

Electoral Division affected:
(All Divisions);

Borrowing from the Municipal Bond Agency

Appendix A and B refer

Contact for further information:
Khadija Saeed, Tel: 01772 536195, Head of Corporate Finance,
khadija.saeed@lancashire.gov.uk

Executive Summary

Following changes introduced by the Government in 2010/11 the cost of the Council borrowing money increased. In response, the Council, as part of a Local Government Association initiative has contributed to the setting up of the Municipal Bond Agency, which is intended to reduce costs.

This report makes recommendations to specifically authorise borrowing from the Municipal Bond Agency (MBA). In order to do so, the Council will need to enter into the Agency's Framework Agreement. The Agreement includes an accession document confirming that the council has the necessary approvals to sign the Agreement and a joint and several guarantee to those lending money to the Agency in respect of the borrowing of all other local authorities from the Agency. Entering into the Framework Agreement enables the Council to access funding from the Agency as and when required which will be at a lower rate than PWLB finance.

In particular the report explains the process by which the MBA is expected to raise money and lend to local authorities. The report goes on to explain why it is considered extremely unlikely that the guarantee will be called but in the event it was, explains in general terms what is expected to happen to restore the position. The report explains how this structure is expected to produce cheaper borrowing for local authorities which outweighs the risks associated with the legal arrangements.

Recommendation

The Full Council is recommended to:

1. Note the risks of entry into the Framework Agreement and Guarantee and of undertaking borrowing from the UK Municipal Bonds Agency.

Lancashire County Council

2. Approve entry into the Framework Agreement (a guide to the framework agreement is at Appendix A).

3. Subject to the above, authorise the Cabinet Member with responsibility for finance to approve any specific borrowing to be undertaken.

4. Subject to the above, delegate authority to the Council's Section 151 Officer and Monitoring Officer to execute all the necessary contractual arrangements.

5. Note that these officers will be required to provide the confirmation at Appendix B that the Council's governance has been completed in relation to entering the Framework Agreement.

Background and Advice

The UK Municipal Bonds Agency (MBA) was established by the Local Government Association (LGA) and 56 local authorities, including Lancashire County Council, for the purpose of enabling local authorities to borrow on better rates of interest than would otherwise be available to the local authority and to provide an alternative to the Public Works Loan Board (PWLB).

The Council became a shareholder in the MBA during 2014-15, following approval at Cabinet on 15 July 2014 to invest £250k equity.

Given the Council's significant borrowing requirement to finance the capital programme over the medium term, it was considered in the Council's interest that the MBA was established so as to reduce financing costs in the years ahead.

In order to be able to borrow from the MBA a local authority must accept the terms of the Framework Agreement and grant joint and several guarantee. This means that a local authority will be guaranteeing all the existing finance obligations of the MBA and any future obligations which are entered into.

This report describes the risks of entering into the Framework Agreement and providing the Guarantee, and the safeguards and protections that are in place to mitigate the Guarantee from being exercised. It also sets out the legal powers relied upon to enter into these contracts.

UK MUNICIPAL BONDS AGENCY – OVERVIEW OF THE MBA

<u>Background to MBA</u>

The Local Government Association (LGA) established the UK MBA in June 2014 with the primary objective of reducing UK local authority financing costs, through becoming the most efficient and cost effective provider of finance.

The MBA will borrow money from a variety of third parties, including local authorities, and on-lend, on a matched funding basis to UK local authorities.

In March 2014 a revised Business Case was published by the LGA containing details as to how a municipal bonds agency would expect to issue bonds on behalf of local authorities in an efficient and cost effective manner and at lower rates than from existing facilities such as the Public Works Loan Board (PWLB).

In order to achieve the most competitive pricing and beat PWLB rates, the MBA will have to be viewed as a strong counterparty and have a strong credit rating, achieved through (amongst others), the following mechanisms:

- A joint and several guarantee granted by each of the borrowing local authorities covering the full amounts owed by the MBA under any financing document which is covered by the guarantee;

- Contribution arrangements, whereby if a local authority defaults on one of it payments to the MBA, the MBA shall require each other local authority that is party to the Framework Agreement to put in funds to cover the shortfall; and

- A very conservative risk profile.

In giving the joint and several guarantees, local authorities will be relying on the MBA to ensure appropriate standards of credit worthiness in relation to each of the local authorities and liquidity management.

MBA's Client Base

The MBA will only lend to UK local authorities who can give a joint and several guarantee. This client base is currently limited to 353 principal English local authorities, which have the general power of competence pursuant to section 1(1) of the Localism Act 2011 (the "General Power of Competence") including the power to give a joint and several guarantee, and which satisfy the terms of the Framework Agreement in relation to accession of local authorities.

The ability to give joint and several guarantees may in due course be extended to other local authorities, e.g. combined authorities or Scottish or Welsh authorities. In the event that this occurs, they will be eligible to borrow from the MBA, subject to appropriate credit checks.

The MBA would, in due course, like all local authority borrowers to become shareholders in the MBA. This ensures a stronger alignment of interest between local authority borrowers and shareholders and is viewed positively by ratings agencies and the markets. Accordingly, the MBA will charge a higher interest rate to local authority borrowers who are not shareholders, albeit one which remains competitive.

Borrowing from the MBA

In order to borrow from the MBA, a local authority will need to enter in to the Framework Agreement with the MBA.

The Framework Agreement detail how the MBA expects to interact with local authority borrowers, including detailing how the joint and several guarantee and contribution arrangements will work and documenting the loan standard terms and condition.

Expected MBA Lending Timeline

The lead up to the initial bond issue will require a degree of coordination as local authorities who wish to borrow from the MBA go through these approval processes and the volume of demand for financing builds.

Once a local authority has signed the required documentation, the MBA will carry out its credit assessments prior to entering into any loan with a local authority. Once the MBA has sufficient borrowing demand built up the process of issuing a bond will commence.

The MBA has completed all the necessary internal steps to be able to issue a bond fund borrowing requirements at short notice. Nevertheless, the MBA will only issue a bond when market conditions are appropriate, and accordingly will look for flexibility within a 2 to 4 week window, once local authorities have committed to borrow.

Pricing of the MBA's loans

The MBA operates a transparent pricing structure. The MBA will charge a margin over its underlying borrowing costs to borrowing local authorities. This margin is currently set at:

- 10 basis points (0.10%) for shareholders; and
- 15 basis point (0.15%) for non-shareholders.

The MBA may adjust these margins for new borrowing transactions at its discretion, but will not increase them. It is expected that over time these margins will reduce.

In addition the MBA will pass on any transaction costs to local authority borrowers. These costs will include: rating agency fees, bank syndicate fees and legal costs. These will not exceed 50 basis points (0.50%) on the total amount borrowed.

Prepayment

Any loans from the MBA will be funded by money borrowed by the MBA from the markets, institutions or local authorities. Prepayment rights will track through between the local authority loans and the MBA financing arrangements. For bond issues, voluntary prepayment is calculated in a similar way as PWLB premature repayment.

Approach to credit assessment of local authorities

Prior to approving any loans, the MBA will carry out a credit review on the local authority.

The MBA has developed proprietary credit scoring models based on similar methodologies to the main ratings agencies. In order to access funding from the MBA,

a local authority would need to be able to achieve a single A credit rating on a stand alone basis (rating agencies would typically “notch up” a local authority to account for implied Government support”).

In addition to credit scoring, the MBA will ensure appropriate diversification of its lending portfolio, through the contractual concentration limits agreed in the Framework Agreement.

Key elements of the Framework Agreement

A guide to the framework agreement is at Appendix A. The Framework Agreement is primarily designed to mitigate the risk of a call on the joint and several guarantee, and lays out contractually how the MBA will interact with local authorities.

The joint and several guarantee will be provided by local authority borrowers, in favour of the underlying providers of finance. The guarantee is required to be unconditional and irrevocable. Accordingly, from the point in time at which the guarantee is executed, a local authority is guaranteeing all the financing obligations of the MBA. Should a local authority give notice to withdraw from the guarantee, including repaying all outstanding borrowings, it will continue to guarantee the borrowing of the MBA which are outstanding at that point in time.

The Framework Agreement mitigates the risk of a call on the joint and several guarantee. It does this in a number of ways:

- It required the MBA to carry out certain processes, e.g. credit check, and not to lend money to local authorities which it believes do not pass the credit assessment;

- It required a level of diversification, which ensures that the MBA does not become overly concentrated in lending to a particular authority;

- It sets out the timelines for payment to ensure that the MBA has funds in place on a timely basis for payments of interest and principal;

- It includes requirement for notification in the event that an authority will have difficulty in meeting its payment obligations.

In addition the MBA will maintain standby liquidity facilities, which are intended to be sized at an amount sufficient to avoid default on an interest payment.

In the event that an authority does not meet its obligation to the MBA on a timely basis, the MBA is required to ask authorities to make contribution (contribution arrangements) to meet the shortfall in proportion to their borrowings, in the form of a contribution loan, to avoid the guarantee being called in.

In the event that a contribution is made, the MBA is required to pursue recovery of the debt, from the defaulting authority, on a timely basis.

Default by a local authority

No principal local authority has default on any loan (from the PWLB, a bank or any other lending institution).

The statutory and prudential framework under which local authorities operate is amongst the strongest in the world.

Any lender to a local authority has protection, under statute, by way of a first charge on the revenue of that authority.

In addition, the reputational damage which would be suffered by a defaulting local authority would be significant.

MBA Credit Rating

The MBA has a private credit rating, which it will make public at the appropriate time. The range of local authority borrowers/guarantors may impact the credit rating.

Governance of the MBA

The MBA is a public limited company and as such is directed by its Board. In due course, it is expected that the Board will include 7 non-executive and 3 executives.

In addition, the Board will have the following 2 sub-committees, chaired by independent non-executives:

- Risk, Compliance and Audit Committee; and
- Nomination and Remuneration Committee.

RISKS AND SAFEGUARDS OF ENTRY INTO FRAMEWORK AGREEMENT

Given the participating local authority's exposure to the contribution arrangements and/or the Guarantee when borrowing from the MBA, it is important to understand that entry in to the Framework Agreement and borrowing from the MBA is therefore very different in nature to borrowing from the Public Works Loan Board, under a bilateral loan facility or through a bond issue in the capital markets.

There are inherent risks associated with the proposed structure for any local authority entering into the Framework Agreement, not least the joint and several nature of the Guarantees that participating local authorities are required to provide before borrowing from the MBA. These are:

- The risk to a participating local authority is that its Guarantee may be called independently of any other Guarantee and for the full amount owing by the MBA under the financing document which is covered by such Guarantee (and, therefore, such participating local authority is potentially liable to pay out amounts to the MBA that vastly exceed the amounts borrowed).

- Participating local authorities should also note that, even after a participating local authority has terminated its Guarantee, it will continue to guarantee the "Guaranteed Liabilities" entered into by the MBA before the date of termination of the Guarantee. The effect of this is that a participating local authority's liability under its Guarantee may potentially continue in existence for many years after termination.

However, the risks associated with the Guarantees are mitigated by the contribution arrangements mechanism. The Framework Agreement is therefore designed such that the real exposure for participating local authorities, from a practical perspective, should be under the contribution arrangements rather than the Guarantees, and the exposure of each participating local authority would be calculated by reference to the amount borrowed by it as a proportion of all non defaulting participating local authorities borrowing under the structure.

Even though the participating local authorities are entitled to expect that the MBA will operate in accordance with its obligations under the Framework Agreement, participating local authorities are nevertheless inevitably exposed to the risk that the MBA fails to observe its obligation under the Framework Agreement. This may include failure to sustain and police robust due diligence and credit assessments on acceding local authorities (therefore making it more likely that the participating local authority will need to contribute over and above their borrowings whether through the contribution arrangement or the Guarantee). It is also possible that the MBA itself may default on its underlying bilateral borrowing from counterparties or under bond issues by not managing its cash flows in a prudent manner or that the MBA may fail to operate the contribution arrangements in a manner as envisaged in the Framework Agreement, in which case, each participating local authority is exposed to a call on it guarantee without the protection that the contribution arrangements provide.

However, the Framework Agreement does contain provision to mitigate the risks identified above, in summary by:

- The contractual obligations upon the MBA to undertake credit assessments of each LA;

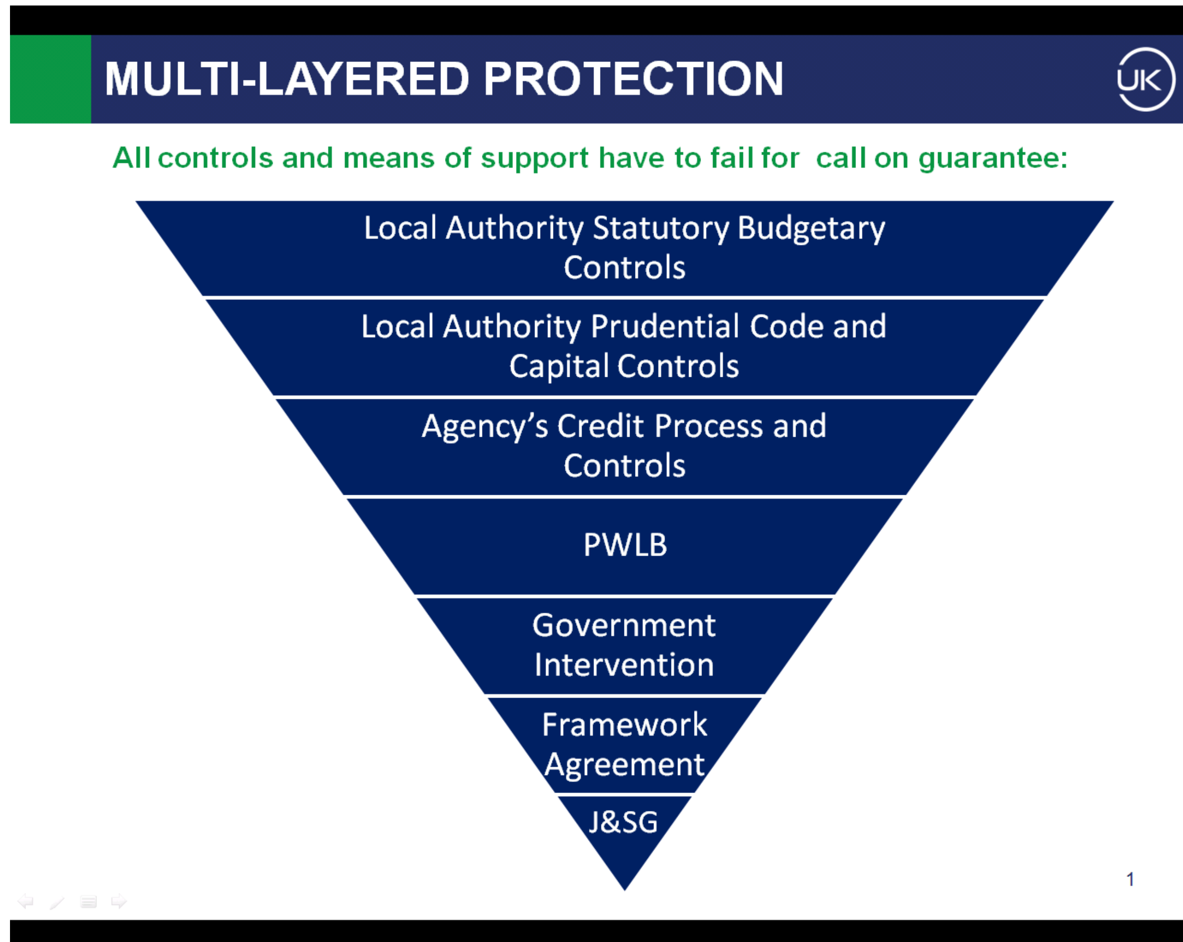
- The limit on the amount each participating local authority may borrow from time to time
- The matched transactions basis on which the MBA itself will borrow money
- The power for participating local authorities to collectively instruct MBA not to undertake further borrowing.

In addition to the above, the statutory and prudential framework under which local authorities operate (set out in summary below), should provide some reassurance to the financial standing of the local government sector:

- Compliance with the prudential framework established by Part 1 of the Local Government Act 2003 and related regulations, including the Prudential Code for Capital Finance in Local Authorities published by CIPFA
- Requirement to set a balanced budget in accordance with Section 31A and Section 42A of the Local Government Finance Act 1992

- The Chief Finance Officer's report on robustness of budget estimates and adequacy of reserves under section 25 of the Local Government Act 2003.
- Requirement to publish audited accounts by a statutory deadline
- External audit opinion in respect of a local authority's accounts.

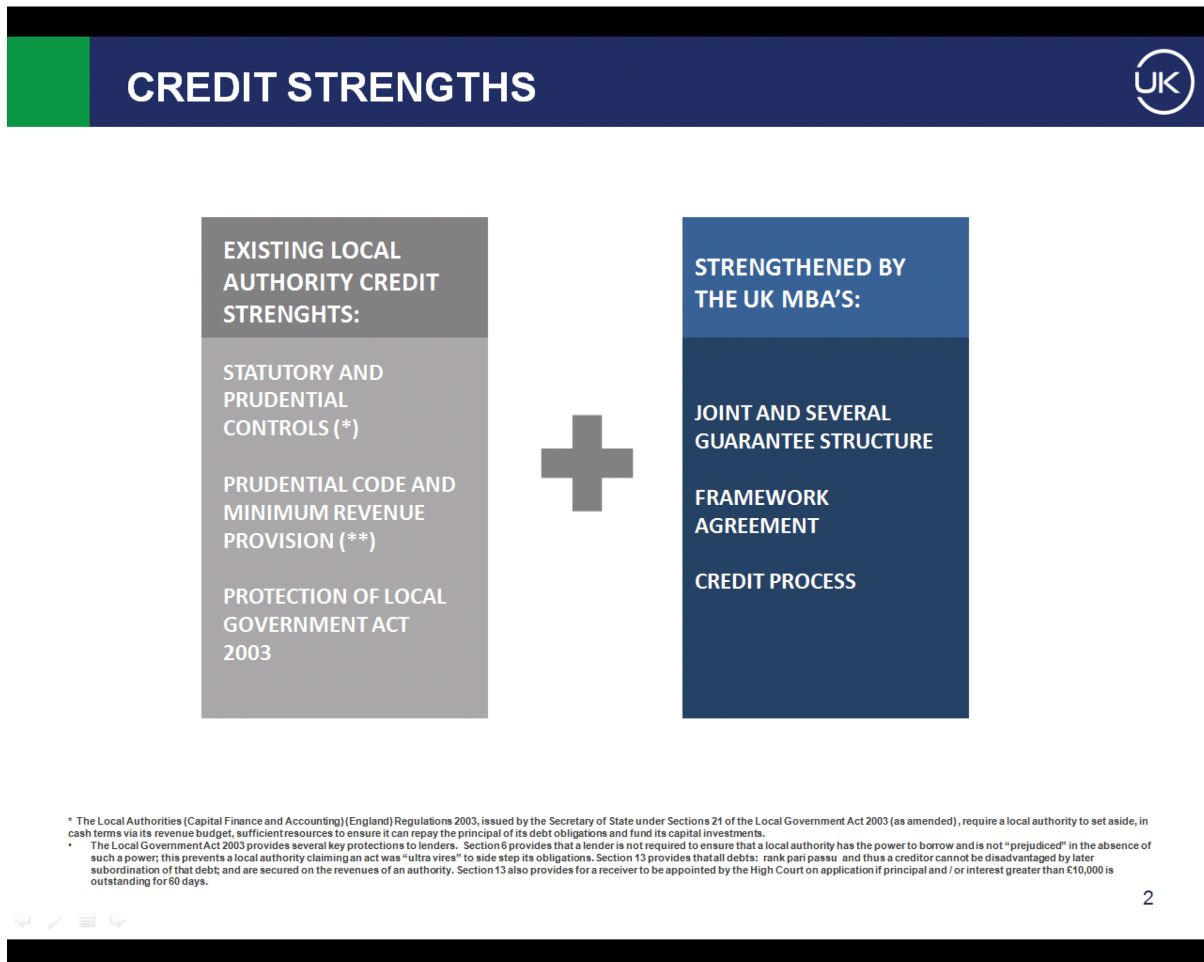
The slides and diagrams below (provided by the MBA) describe the layers of controls and safeguards in place that have to fail before the call on the guarantee is exercised.



The local authorities (Capital Finance and Accounting) (England) Regulations 2003, issued by the Secretary of State under Sections 21 of the Local Government Act 2003 (as amended), require a local authority to set aside, in cash terms via its revenue budget, sufficient resources to ensure it can repay the principal of its debt obligations and fund its capital investments.

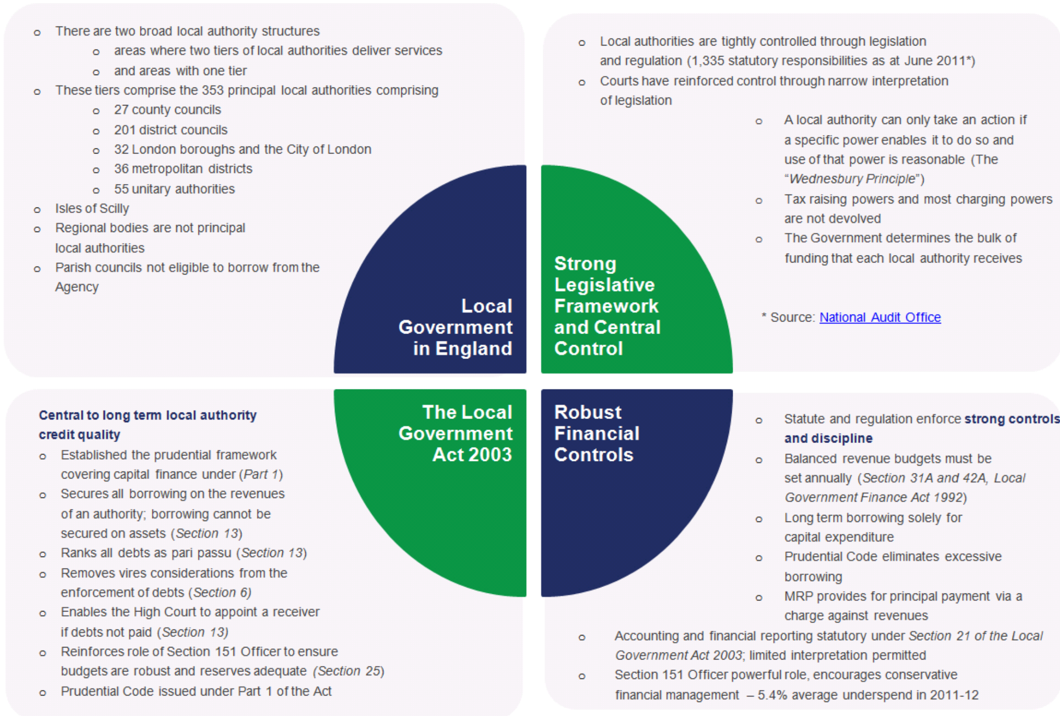
The Local Government Act 2003 provides several key protections to lenders. Section 6 provides that a lender is not required to ensure that a local authority has the power to borrow and is not "prejudiced" in the absence of such a power; this prevents a local authority claiming an act was "ultra vires" to side step its obligations. Section 13 provides that all debts: rank pari passu and thus a creditor cannot be disadvantaged by later subordination of that debt; and are secured on the revenues of an authority. Section 13 also provides for a receiver to be appointed by the High Court on application if principal and / or interest greater than £10,000 is outstanding for 60 days.

The slide below describes that the existing local authority credit strengths are strengthened by the MBA's Framework Agreement, Guarantee and Credit Process.



This slide describes the strong legislative framework that local authorities operate within which should provide some reassurances to institutions providing loans to local authorities, through the MBA, as well as local authorities signing providing guarantee.

LOCAL AUTHORITIES ARE HEAVILY SUPERVISED



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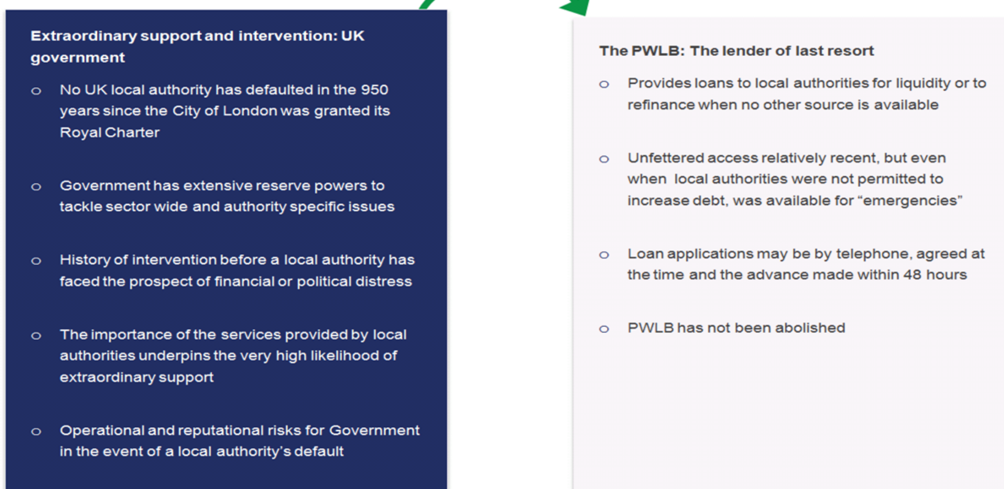
The PWLB remains the lender of last resort and may be used by local authorities for liquidity purposes or to refinance loans at short notice.

UK GOVERNMENT INTERVENTION

& THE ROLE OF THE PWLB AS LENDER OF LAST RESORT



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Conclusion

In providing a guarantee in order to be able to borrow via the MBA, the risks that arise must be considered. Exposure to the contribution arrangements and the joint and several guarantee means that entering into the Framework Agreement and borrowing via the Agency is different in nature to borrowing from the Public Works Loan Board, under a bilateral loan facility or through a bond issue in the capital markets.

There are inherent risks associated with the proposed structure, not least the joint and several nature of the guarantee. These are:

- The risk that the Council's guarantee may be called independently of any other Guarantee and for the full amount owing by the Agency under the financing document that is covered by the guarantee (and, therefore, the Council would be potentially liable to pay out amounts to the MBA that exceed the amounts borrowed).

- Even if the Council has terminated its Guarantee, it will continue to guarantee the "Guaranteed Liabilities" entered into by the Agency before the termination date (until such time as those liabilities have expired, as the underlying loan has been repaid). The effect of this is that the Council's liability under its Guarantee may potentially continue in existence for many years (several decades) after termination.

However, the risks associated with the joint and several guarantee are mitigated by the contribution arrangements. The Framework Agreement is such that the Council's exposure, from a practical perspective, is the requirement to make contributions in the event of a default by another borrower and this exposure is proportional because it is calculated by reference to the amount borrowed by the Council as a proportion of all non-defaulting loans made by the Agency.

The risk of a default by a local authority is considered to be low with the ability of the Agency to recover sums owed to it in the event of a default set out in this report.

There is a risk that the Agency does not observe its obligations under the Framework Agreement, but the Council is entitled to expect that the Agency will operate in accordance with its obligations under the Framework Agreement when considering whether or not to enter into the Framework Agreement. The LGA and local authorities control the Agency via their shareholdings so could intervene if the Agency did not abide by the Framework Agreement.

Benefits

The prime advantage to the Council is the prospect of lower borrowing costs and the possibility to obtain types of loans that are not available from the PWLB. Cheaper capital finance will reduce pressure on the Council's finances. This advantage offsets the low risk that a local authority defaults and the Agency is unable to recover the debts owed to it in order to repay the Council any contributions it is required to make.

When the Agreement comes into effect

The Framework Agreement only comes into effect if the Council does borrow from the Agency. If the Council does not borrow, there is no risk to the Council arising from the contribution arrangements or joint and several guarantee. The Council is not obligated to borrow via the Agency and even if it chooses to legally commit to borrowing via a bond issue, it will not be required to take a loan that is not cheaper than the PWLB, so the bond will not be issued. Therefore, the financial risk to the Council of the Agency either failing to deliver a saving or the Council not borrowing having signed the Framework Agreement is effectively eliminated.

Wider Observations about LA Borrowing Risk

All borrowing of the MBA will be done for and on behalf of local authorities. The major credit reference agencies have considered local authorities as a sector.

Moody's has observed:

LAs are highly regulated by the Department of Communities and Local Government, and ultimately the national government. A number of measures are in place to ensure LAs deliver fiscal discipline, including the requirement to put forward balanced budgets, have council tax rates approved annually, and to implement the Prudential Code for Capital Finance in Local Authorities, which limits the levels of borrowing. There are currently no signs of this regulatory framework or the associated oversight weakening. In addition, the Secretary of State has additional powers of intervention if a council is on the verge of financial distress, if needed.

And Standard & Poors have observed:

"If a council were to default we consider the legislation to be favorable to creditors, and we would expect high recovery rates. The Local Government Act 2003, for example, mandates that all money borrowed by a local authority, together with any interest on the money borrowed, "shall be charged indifferently on all the revenues of the authority." In the event of a default, the High Court may confer on a receiver any powers which the local authority has in relation to collecting, receiving, or recovering the revenues of the local authority. Given the potential implications of a default, particularly in terms of loss of control over revenue and therefore service delivery, councillors and their officers have a strong disincentive against willingly defaulting on their financial obligations.

…Broadly speaking, we consider that the sector has a strong technical capacity to deliver spending reductions.

… the sector has shown a strong track record of monitoring and controlling expenditure. Council officers typically provide monthly financial reports to their councillors, and the U.K. Department for Communities and Local Government (DCLG) monitors quarterly financial returns. We understand that DCLG continues to play an active role in responding to councils that are under financial stress. Although the decision to close the Audit Commission has reduced the extent of local authority reporting, we still consider that, from a credit perspective, the U.K. local authority

sector benefits from a high degree of transparency and effective monitoring and financial controls."

In essence both agencies are saying that lenders to the local government sector should have a high level of confidence in getting debt repaid and interest payments in line with expectations. Effectively the guarantee provides additional assurance and in the event that contributions were required the MBA would be in a position to recover them through the High Court, relying on the charge borrowings place on revenues.

The risk associated with the guarantee is therefore considered low, and the risk associated with any loan does not really depend upon the lender; it is a market risk which we already have, though as indicated above the MBA is expected to be able to lend more cheaply than the PWLB.

However, given the specific risks and guarantees around this borrowing it is concluded that subject to the Council's approval to enter into the Framework Agreement, borrowing from the MBA is not undertaken without the express approval of the Council's Cabinet Member with responsibility for finance in relation to each loan undertaken.

Additionally, in order to access borrowing from the UK MBA, local authorities will need to be able to demonstrate that those signing the guarantee and related documents have the appropriate authorisation. This protects both the UK MBA and other participating local authorities. To facilitate this, the UK MBA requires a certificate of approval (Appendix B) to be signed by both the S151 officer and the monitoring officer, which identifies the chain of authority from the local authority to the relevant signatories and demonstrates that the local authority has appropriate approval to enter into the Framework Agreement and the relevant guarantee.

Consultations

N/A

Implications:

This item has the following implications, as indicated:

Financial

Due to the changing environment within financial markets following the EU referendum outcome, any decision to borrow from the MBA will need to consider the market conditions at the time of any bond issue.

Legal

Legal advice as to the powers required by participating local authorities was sought from external lawyers who were satisfied that there were no vires issues.

Risk management

As set out in this report

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Tel
Financing the County Council's Borrowing Requirement	15 July 2014	Mike Jensen, (01772) 538724

Reason for inclusion in Part II, if appropriate

N/A