Full Council

Thursday, 13th October, 2016, Council Chamber, County Hall, Preston

Question time begins at 1.30 pm.

Full Council begins at 2pm or at the end of Question Time, whichever is earlier.

Supplementary Agenda

We are now able to enclose, for consideration at the next meeting of the Full Council on Thursday 13 October 2016, the following information which was unavailable when the agenda was despatched.

Index

Jo Turton
Chief Executive

County Hall
Preston

11 October 2016

Agenda Item 4

Meeting of the Full Council
Meeting to be held on 13 October 2016

Report submitted by: Director of Financial Resources

Part A

Electoral Division affected:
(All Divisions);

Borrowing from the Municipal Bond Agency
(Appendices 'A', 'B' and 'C' refer)

Contact for further information:
Neil Kissock, Tel: 01772 536154, Director of Financial Resources,
neil.kissock@lancashire.gov.uk

Executive Summary

The Municipal Bond Agency has been established to give local authorities access to borrowing at cheaper rates than those given by the Public Works Loans Board (PWLB). To have access to the borrowing facility the County Council must sign up to a framework agreement issued by the Agency. A report on the Bond Agency was submitted to the County Council on 21 July 2016 which is attached as Appendix 'A'.

County Council resolved that the "*Audit and Governance Committee be requested to examine the potential risks of the County Council entering into the Framework Agreement and the possible mitigation of those risks at its meeting on 26 September 2016 and a further report be presented to Full Council on 13 October 2016*".

The Audit and Governance committee, on the 26 September, considered the risks and mitigations, and resolved that Full Council be recommended to agree that the County Council enters into the UK MBA framework agreement as set out in the report. The report to the Audit and Governance committee is attached as Appendix 'C'.

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 Bond Agency;
2. Approve entry into the Framework Agreement;
3. Subject to the above, authorise the Cabinet Member with responsibility for finance to approve any specific borrowing with the terms and undertaking of

Lancashire County Council

any loan being subject to the approval of the Council's S151 Officer taking into consideration the potential liability being incurred from the guarantees, relative to the other borrowing options available to the Council at the time;

4. Subject to the above, delegate authority to the Council’s Section 151 Officer and Monitoring Officer to execute all the necessary contractual arrangements; and
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 Municipal Bond Agency (MBA) has been established to give local authorities access to borrowing at cheaper rates than those given by the Public Works Loan Board (PWLB). To have access to the borrowing facility the County Council must sign up to a Framework Agreement issued by MBA. A report on the MBA was submitted to the County Council on 21 July 2016 which is attached as Appendix 'A'.

County Council resolved that the "*Audit and Governance Committee be requested to examine the potential risks of the County Council entering into the Framework Agreement and the possible mitigation of those risks at its meeting on 26 September 2016 and a further report be presented to Full Council on 13 October 2016*".

The Audit and Governance committee, on the 26 September, considered the risks and mitigations, and resolved that Full Council be recommended to agree that the County Council enters into the MBA Framework Agreement as set out in the report. The report to the Audit and Governance Committee is attached as Appendix 'C'.

Following discussions with Group Leaders it has been clarified that the joint and several guarantee that local authorities must give when borrowing money only takes at effect at that stage, it does not apply simply by virtue of entering into the Framework Agreement. The risk of entering into the guarantee only therefore arises where the Council join in a bond issue.

Where a borrower defaults then the agreement with MBA means that MBA will require contributions from non-defaulting authorities proportionate to their borrowings in order to satisfy the loan. These contributions take effect as further loans made from the non-defaulting local authorities which then attract interest, the MBA being required to then pursue the defaulting authority for recovery.

However, if the joint and several guarantee is triggered, then the nature of the guarantee is such that if a borrower defaults then, whilst the agreement with the MBA is as described above, a lender may, in theory, pursue recovery directly against any of the local authority guarantors.

The risk of this latter scenario is however considered to be extremely remote, in effect the arrangement is predicated on the premise that a local authority cannot go out of business. The purpose of the guarantee is essentially to provide confidence to lenders and also to enable the MBA to issue bonds without issuing a prospectus for each bond issue or having to undertake credit assessments of individual borrowing authorities.

A fuller explanation of the mechanism and associated risks is set out in Appendix A.

Given the specific risks and guarantees around this borrowing it is recommended that subject to the Council's approval to enter into the Framework Agreement, specific borrowing from the MBA is not undertaken without the express approval of the Council’s Cabinet Member with responsibility for finance and the Council's S151 Officer taking into consideration the potential liability being incurred from the guarantees, relative to the other borrowing options available to the Council at the time.

In order to access borrowing from the 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 MBA and other participating local authorities. To facilitate this, the 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:

Risk management

If the Council does not sign up to the MBA framework agreement, the opportunity to secure long term borrowing below the PWLB rate may not be available under desirable terms.

Financial

As set out in the report and the background papers

Legal

As set out in the report and appendices

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

Paper	Date	Contact/Tel
The County Council's Treasury Management Strategy 2016/17	26 September 2016	Khadija Saeed, Head of Corporate Finance, 01772 536195
Financing the County Council's Borrowing Requirement	15 July 2014	Mike Jensen, Chief Investment Officer 01772 538724

Reason for inclusion in Part II, if appropriate

N/A

Appendix 'A'

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

Full Council is recommended to:

1. Note the risks of entry into the Framework Agreement and Guarantee, and 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;

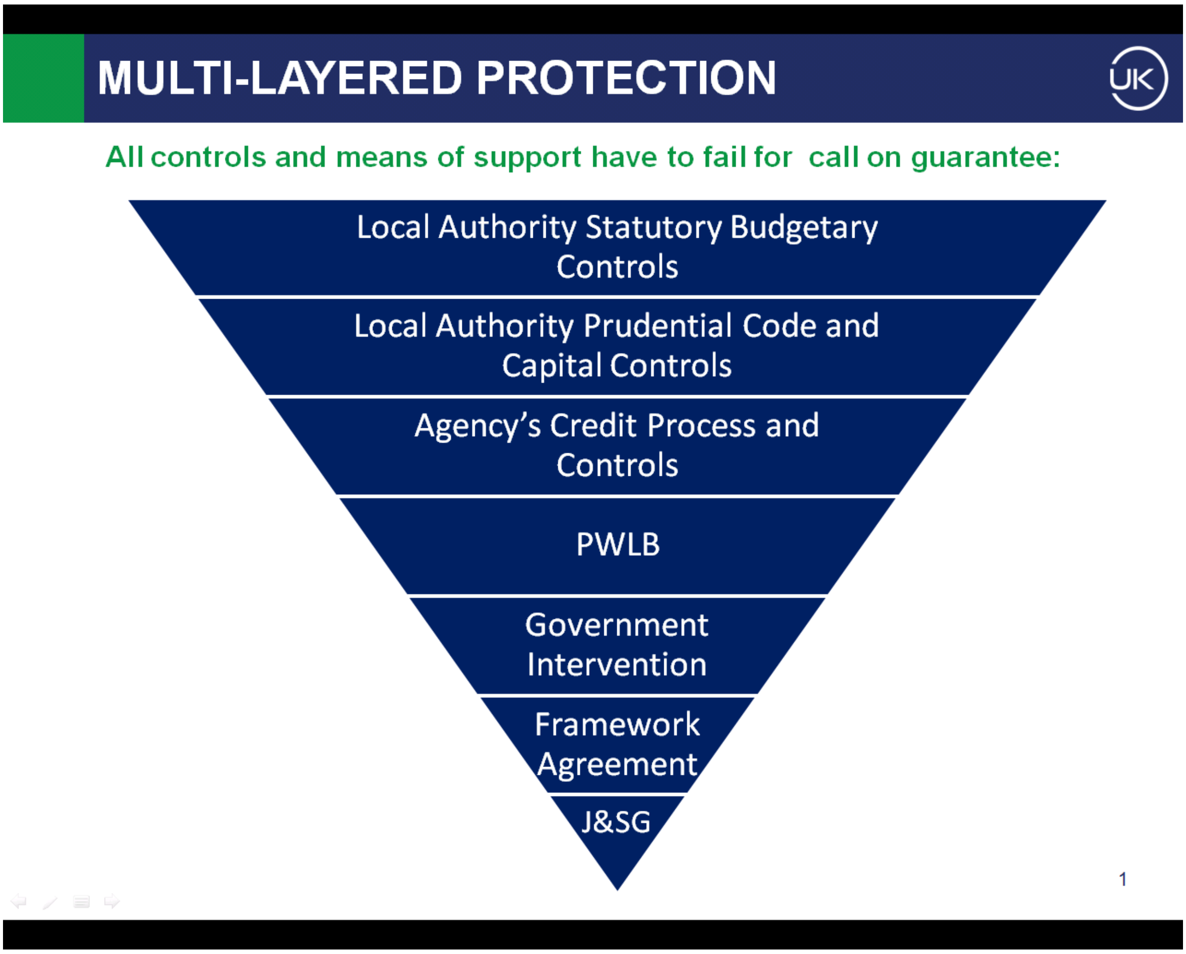
- The limit on the amount each participating local authority may borrow from time to time
- The matched transactions basis on which the MBA itself will borrow money
- The power for participating local authorities to collectively instruct MBA not to undertake further borrowing.

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.

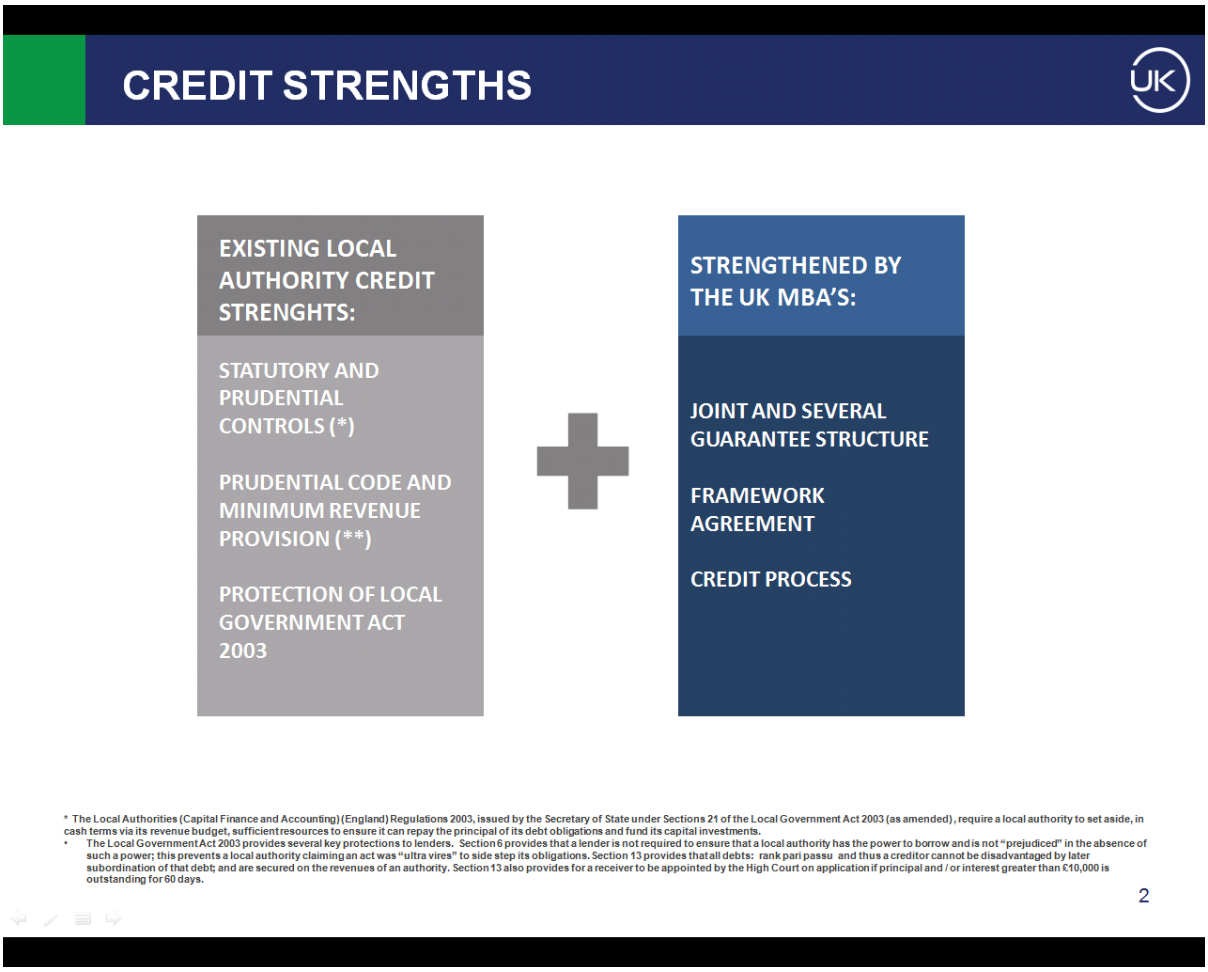
The slides and diagrams below (provided by the MBA) describe the layers of controls and safeguards in place that have to fail before the call on the guarantee is exercised.



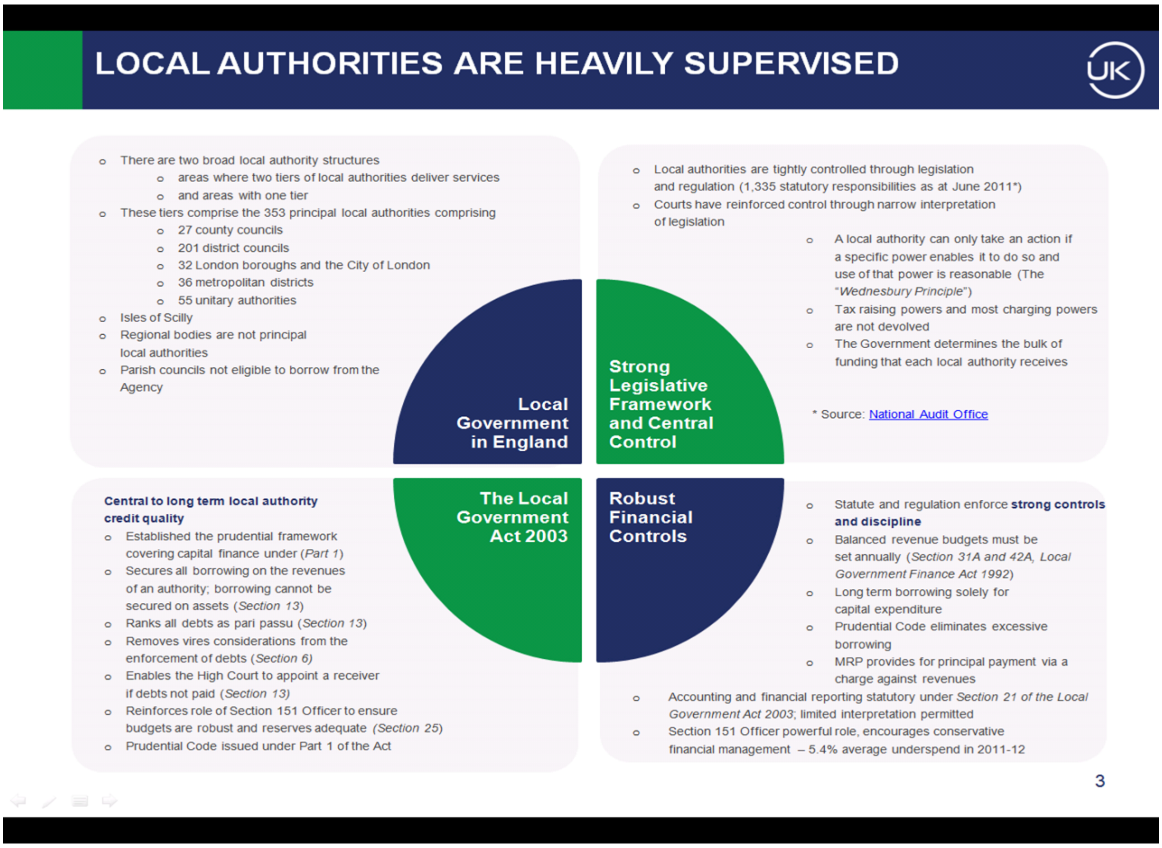
The local authorities (Capital Finance and Accounting) (England) Regulations 2003, issued by the Secretary of State under Sections 21 of the Local Government Act 2003 (as amended), require a local authority to set aside, in cash terms via its revenue budget, sufficient resources to ensure it can repay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

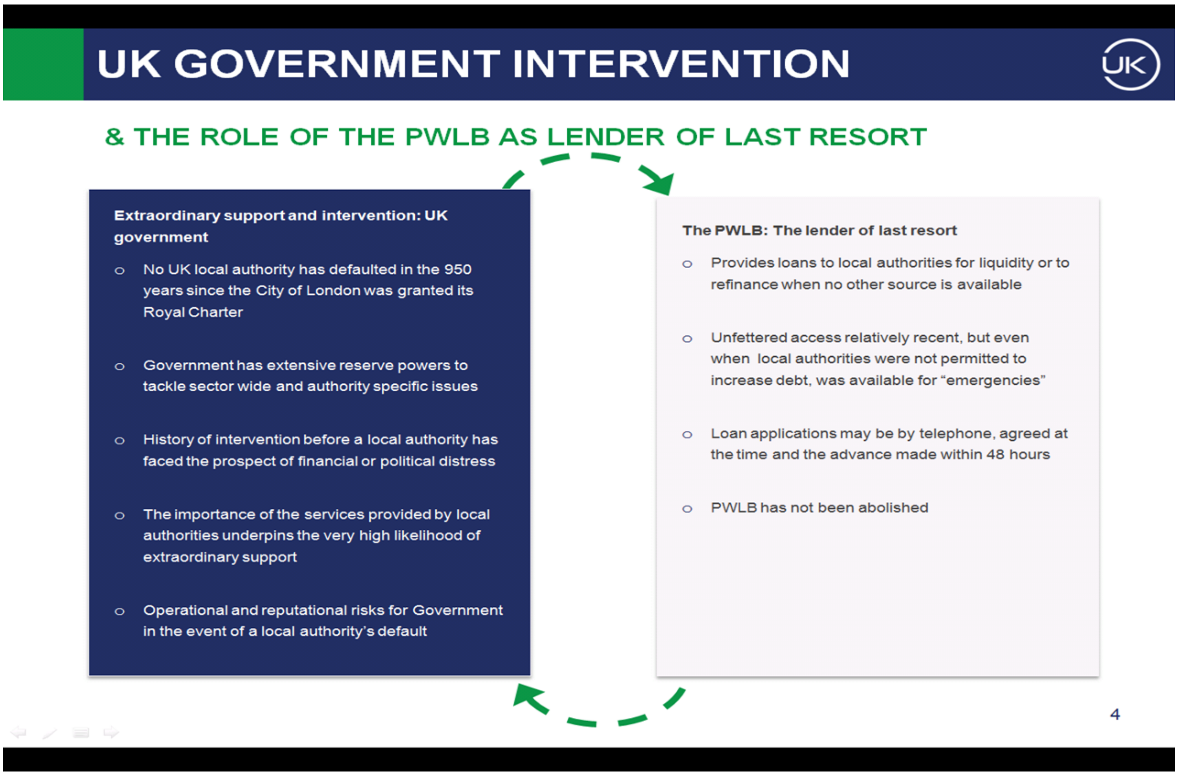
The slide below describes that the existing local authority credit strengths are strengthened by the MBA's Framework Agreement, Guarantee and Credit Process.



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.



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.



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.

<u>Benefits</u>

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

Guide to the Framework Agreement

This Appendix A (*Guide to the Framework Agreement*) is intended to be a summary only, providing ease of accessibility to, and not a substitute for, the detail of the Framework Agreement. This summary is entirely subject to the terms of the Framework Agreement, which should be read in full and shall at all times take precedence (including in the event of a dispute).

Joint and several guarantee

The joint and several guarantee ("the guarantee") is irrevocable and unconditional.

The guarantee will become effective when it is executed (which the UK MBA envisages will be at the point in time at which the UK MBA first provides financing to the respective local authority). At that point in time, the local authority will be guaranteeing all existing finance obligations of the UK MBA and any future finance obligations which are entered into prior to the local authority giving notice to terminate the guarantee.

A local authority can only give notice to terminate the guarantee when it has no outstanding loans from the UK MBA. The irrevocable nature of the guarantee means that, at that point in time, it will continue to guarantee the finance obligations which are in place when notice to withdraw is given. However, it will not be guaranteeing any future financing obligations of the UK MBA.

Contribution arrangements and mechanism

In order to mitigate the risk of a call on the guarantee, contribution arrangement mechanics have been built into the Framework Agreement.

Contribution arrangements enable the UK MBA, in the event of a failure by a local authority to meet a payment obligation within the time frames set out under the Framework Agreement, to call proportional contributions from other borrowing authorities. These timeframes, which are specified in section 3.3 of the Framework Agreement, can be summarised as follows:

1. Payment of interest must be made to the UK MBA by 11am on the fifth business day preceding the due date of such amount under the loan made by the UK MBA to the relevant local authority. For payments of principal and unless otherwise agreed between the UK MBA and the relevant local authority, it is the tenth business day.

2. If any of these payments have not been made and the UK MBA is unable to obtain sufficient funds by other means by 11am the following day in the case of interest or 2 days after the required date of payment (unless otherwise agreed between the UK MBA and the relevant local authority) in the case of principal, bearing in mind that the UK MBA is obliged to send follow up demands, the UK

MBA shall (by 5pm on such day) issue a contribution notice to each non-defaulting local authority (a "**Contribution Notice"**).

3. Each Contribution Notice will request each non-defaulting local authority to provide contributions calculated by reference to the proportion of the shortfall equal to its borrowings as a proportion of the borrowings of all non-defaulting local authorities from the UK MBA. Some non-defaulting local authorities' contributions will therefore be zero (where such non-defaulting local authority has no outstanding borrowings from the UK MBA).

4. Contributions must be made by 11am on the date specified in the relevant Contribution Notice which shall be at least 2 business days after the date of the Contribution Notice in the case of interest or 4 business days after the date of the Contribution Notice (unless otherwise agreed between the UK MBA and the relevant local authority) in the case of principal.

5. Should any local authority fail to pay any contribution due under a Contribution Notice, the UK MBA shall issue notices to the other non-defaulting local authorities (a "**Further Contribution Notice**"), requiring a further contribution by 11 am the following business day in the case of interest or 2 business days after the date of such Further Contribution Notice in the case of principal. The UK MBA may, however, elect not to carry out this process if it has obtained the required funds by other means.

The UK MBA may also by agreement with any non-defaulting local authorities issue notices to such local authorities requiring them to pay in aggregate an amount equal to the shortfall less the contributions that have been made (an "**Individual Authority Contribution Notice**").As indicated at 3 above, contributions by a non-defaulting local authority are calculated by reference to the proportion of the shortfall equal to that local authority's borrowings as a proportion of the borrowings of all non-defaulting local authorities from the UK MBA. For example, if the UK MBA had £110million outstanding loans equally to 11 authorities and one defaulted on a £10million repayment, then each of the remaining 10 would be asked to make a £1million contribution.

Any contributions are in the form of loans to the UK MBA, upon which interest would be payable. The UK MBA is obliged, under the Framework Agreement, to pursue any defaulting authority on a timely basis for full repayment of any outstanding defaulted amounts, and shall use recoveries to repay local authorities which have made any payments under the guarantees or made contribution loans.

Further details of the timelines for payment of interest and principal and related timings for Contribution Notices are contained in the Framework Agreement. The UK MBA may use other liquidity facilities to cover a default, but, if it is unable to do so, Contribution Notices will be sent.

For worked examples of the contribution arrangements, see page [11] of this Appendix A.

Prepayment

Prepayment of a loan from the UK MBA to a local authority (the "**Loan**") may occur under the following circumstances:

Illegality Prepayment

If, in any applicable jurisdiction, it becomes unlawful for the UK MBA to perform any of its obligations as contemplated by the loan agreement or to fund or maintain the Loan:

1. the UK MBA shall promptly notify the relevant local authority upon becoming aware of that event whereupon the facility will be immediately cancelled; and

2. the relevant local authority shall repay the Loan on the interest payment date (as specified in the relevant loan confirmation) immediately following the date on which the UK MBA has notified such local authority, or if earlier, the date specified by the UK MBA in the notice delivered to such local authority, together with interest accrued (if any).

Mandatory prepayment of funding arrangements

If the UK MBA is required to prepay any funding which the UK MBA entered into in order to fund the making of the Loan, the UK MBA shall promptly notify the relevant local authority of such requirement and such local authority shall repay the Loan on the interest payment date (as specified in the relevant loan confirmation) immediately following the date on which the UK MBA has notified such local authority, or if earlier, the date specified by the UK MBA in the notice delivered to such local authority, together with interest accrued (if any).

Voluntary Prepayment for Tax

If a local authority is required to pay any additional amounts pursuant to clause 9 (Tax Gross Up) of the loan standard terms, the local authority may elect to prepay the Loan in whole on any interest payment date (as specified in the relevant loan confirmation) at the prepayment amount specified in the loan confirmation on such local authority giving not less than 60 days' notice to the UK MBA (which notice shall be irrevocable and shall oblige such local authority to prepay the Loan in whole plus accrued interest (if any) to such date).

Change of Status

If at any time a local authority ceases to be treated as a “local authority” within the meaning of the Local Government Act 2003 and the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003 or equivalent legislation due to legislative amendment (a “**Change of Status**”), the UK MBA may by notice to the local authority require it to prepay the Loan on the interest payment date (as specified in the relevant loan confirmation) immediately following the date of such notice, together with interest accrued (if any).

Voluntary Prepayment

Unless otherwise specified in the relevant loan confirmation, the Loan may be prepaid at the option of the relevant local authority in whole or in part on any voluntary prepayment date at the prepayment amount (both as specified in the relevant loan confirmation) on such local authority giving not less than 60 days' notice to the UK

MBA, or such other period(s) as may be specified in the relevant loan confirmation (which notice shall be irrevocable and shall oblige such local authority to prepay the Loan in whole or, as the case may be, in part, as specified in such notice on the relevant voluntary prepayment date at the prepayment amount plus accrued interest (if any) to such date), provided that the Loan may not be voluntarily prepaid prior to the date falling 12 months after the utilisation date or following the date falling 12 months prior to the final repayment date (both as specified in the relevant loan confirmation).

No other prepayment

No local authority shall, without the prior written consent of the UK MBA, be entitled to prepay the Loan otherwise than as provided in clauses 6.1 to 6.5 of the loan standard terms.

Default by a local authority

Default by a local authority is likely to result in material reputational damage to that authority. The UK MBA is required to notify participating local authorities of the relevant default.

In addition, the Framework Agreement requires the UK MBA to promptly take action to recover any defaulted amounts, which may involve an application to the High Court.

Any costs related to pursuit of a default, including administration costs and interest on contributions, would be a cost to the defaulting local authority, which the UK MBA would pursue. The UK MBA has no authorisation, from participating authorities or shareholders, to negotiate forgiveness of either the outstanding debts or costs.

An event of default is primarily a failure by that local authority to meet a payment, when due, but will also include (amongst other things):

- the appointment of a receiver by the High Court under Section 13(5) of the Local Government Act 2013 in respect of that local authority; and
- the dissolution of that local authority, other than in the creation of a statutory successor.

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 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.

Concentration limits

Concentration limits restrict the UK MBA's ability to become over-exposed to a single local authority, thus ensuring that, in the event of a default, contributions to that default will be spread amongst a wide group of local authorities. These concentration limits are detailed in section 5.2 of the Framework Agreement. It should be noted that concentration limits are tested at the point in time that a local authority borrows, i.e. if local authorities merge to become combined authorities, those limits may be breached. However, as per section 5.2 of the Framework Agreement, in the event of any reorganisation of local authorities, the UK MBA may propose amendments to the concentration limits for approval by 85% of participating authorities.

Matched Financing Arrangements

The UK MBA shall only borrow funds (i) intended to be on-lent to the local authorities (and in any event amounts borrowed by the UK MBA shall at no time be more than 105% of the total outstanding loans it has made to local authorities), where the interest rates on the on-loans will be at least equal to the rate paid by the UK MBA, or (ii) to meet payment obligations in the event of a default by any local authority.

Power of LAs to restrict UK MBA borrowing

Participating local authorities may instruct the UK MBA not to enter into any further borrowing commitments, either under any finance documents or through the issuance of bonds, provided that the number of such local authorities is more than 50% of the number of all participating local authorities and the outstanding loans of such local authorities amount to more than 50% by value of the total outstanding loans. This shall not restrict the ability of the UK MBA to borrow further amounts under any finance document (including under any liquidity facility) or contribution loan to meet a payment obligation under a finance document.

This may occur, for example, if local authorities become concerned about the credit standards of the UK MBA or there is a fundamental change in the statutory or prudential framework.

Loan standard terms

Loan standard terms protect both the UK MBA and the local authorities borrowing from the UK MBA. Any amendments to the standard terms must be agreed between both the UK MBA and the relevant borrowing local authority. Each loan agreement with a local authority will consist of the standard terms as supplemented by a loan confirmation specifying specific details for that particular loan.

Increased Costs

Where the UK MBA has made a Loan to a local authority, the relevant local authority shall, within three business days of a demand by the UK MBA, pay for the account of the UK MBA the amount of any Increased Costs (as described below) incurred by the UK MBA as a result of:

- the introduction of or any change in (or in the interpretation, administration or application of) any law or regulation after the date of the loan agreement; or
- compliance with any law or regulation made after the date of the loan agreement.

Increased Costs include: (i) a reduction in the rate of return from the Loan or on the UK MBA's overall capital, (ii) an additional or increased cost, or (iii) a reduction of any amount due and payable under the loan agreement, in each case which is incurred or suffered by the UK MBA to the extent that it is attributable to the UK MBA having entered into a commitment or funding or performing its obligations under the loan agreement.

The obligation on the relevant local authority to pay any Increased Costs does not apply to the extent that such Increased Cost is:

- attributable to a deduction or withholding for or on account of UK taxes required by law to be made by the relevant local authority; or
- attributable to the wilful breach by the UK MBA of any law or regulation.

Confidential information

Much of the information which the UK MBA uses is available from public sources. Nevertheless on occasions, as part of the UK MBA’s credit assessments, the UK MBA may receive information which is not available publicly.

The UK MBA shall assume that any information that it has received which is not in the public domain is the confidential information of the provider. This does not include information which is required to be disclosed to the UK MBA under section 6.2 of the Framework Agreement (see "*Information Requirements*" below, where the UK MBA may disclose the information to legitimately interested parties, at its discretion).

Similarly, the UK MBA will be providing local authorities with confidential information. For example, the UK MBA views its credit assessments, along with the underlying models, as being confidential. Any confidential information provided to an authority by the UK MBA will be identified as such.

The UK MBA needs to comply with the Market Abuse Directive in relation to the treatment of material price sensitive information. For such information, the UK MBA needs to ensure it is held confidential until it is appropriately communicated to the market. In addition to the credit assessments, such information may include details of authorities granting, or terminating, their guarantee.

Information Requirements

A local authority is required to notify the UK MBA, in writing, where there are indications that such local authority’s financial or operational performance may give rise to concerns over its ability to meet its obligations under any lending arrangements. In particular, the local authority shall notify the UK MBA:

- if it is unable to pay its debts as they fall due;
- of any report issued in respect of it under Section 114 of the Local Government Finance Act 1988 (or any replacement or equivalent provision);

- of any failure to comply 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, as amended or reissued from time to time;

- of any failure to set a balanced budget in accordance with Section 31A and Section 42A of the Local Government Finance Act 1992;

- if the chief finance officer's report on robustness of budget estimates and adequacy of reserves under section 25 of the Local Government Act 2003 states either that the estimates are not robust and/or the reserves are inadequate, and such local authority passes that budget without action to remedy those deficiencies;

- if external auditors issue a qualified audit opinion in respect of such local authority's accounts;

- if such local authority is or will be unable to publish audited accounts by the statutory deadline;

- of any Change of Status of such local authority;

- promptly upon becoming aware that any representation or statement made or deemed to be made by it in the Framework Agreement, any loan agreement or any other document delivered by or on behalf of it in relation to such documents was incorrect or misleading when made or deemed to be made;

- promptly upon becoming aware of them, the status and description of any dispute, litigation, arbitration, expert determination or administrative proceedings which are current, threatened or pending against such local authority, which is reasonably likely to be adversely determined, and which, if adversely determined either individually or taken as a whole, are reasonably likely to have a material adverse effect on the status or governance of the local authority, its assets, its operations, its condition (financial or otherwise), its prospects, or its ability to comply with the finance documents;

- promptly upon becoming aware of them, any event or circumstance which such local authority reasonably believes might have a material adverse effect on the status or governance of the local authority, its assets, its operations, its condition (financial or otherwise), its prospects, or its ability to comply with the finance documents; or

- promptly on request, such additional information as may be reasonably requested by the UK MBA from time to time,

and, in each case, the local authority shall set out in such notice reasonable details associated therewith, the effects of such an event or occurrence and any actions being undertaken to mitigate or remedy such event or occurrence.

Modification

Any modification to the Framework Agreement requires an agreement between the UK MBA and (unless otherwise specifically provided in the Framework Agreement) local authorities being more than 85% of the number of all participating local authorities and where the value of outstanding loans of such local authorities is greater than 85% of the total outstanding loans, provided that no modification to the Framework Agreement which imposes additional obligations on a particular local authority will be made without the consent of that local authority.

Resignation of LAs and termination of guarantees

A local authority may terminate its joint and several guarantee by giving written notice to the UK MBA. In order to terminate the joint and several guarantee, the local authority must have repaid all its outstanding loans from the UK MBA.

If a local authority terminates its joint and several guarantee, it shall no longer be eligible to borrow from the UK MBA, unless it repeats the accession process.

Upon termination, a local authority will continue to guarantee the UK MBA's borrowings which were in place at the time of termination until they are fully repaid.

Enforcement and application of proceeds

The UK MBA is obliged under the Framework Agreement to pursue any defaulting authority for full recovery, using whatever means available.

In particular, the UK MBA may:

- declare such local authority's liabilities to the UK MBA to be immediately due and payable;
- sue for, commence or join any legal or arbitration proceedings against the defaulting local authority;
- exercise any rights of set off; or
- apply to the High Court to have a receiver appointed under Section 13(5) of the Local Government Act 2013.

If the UK MBA does not take steps to recover any defaulted amounts within 90 days of the relevant failure to pay, the UK MBA shall take such action as is reasonably required by the majority of local authorities (where the majority in such case will be met if the number of such local authorities is more than 50% of the number of all participating local authorities and the value of outstanding loans of such local authorities is greater than 50% of the total outstanding loans).

Any amounts recovered by the UK MBA shall be applied in the following order of priority:

- in discharging any amounts owing to the UK MBA's creditors;
- in payment to the local authorities which have made a payment under their guarantee; and
- in payment to the local authorities which have made a contribution, with prioritisation based on the basis for the contributions, i.e. Individual Authority Contribution Notice, Further Contribution Notice and Contribution Notice.

Any amounts payable to local authorities shall be pro-rata to the total amounts of contributions in the relevant category made by such local authorities.

Worked examples

In the following worked examples assume the following:

- Minimum diversification: The UK MBA's total loan book is split between local authorities in such a manner as will meet its minimum requirements in terms of the total number of authorities and the amounts owing by any individual authority.
- Single name limit: The maximum amount which can be owed by any individual authority within a total loan book banding.

Single bond in issue, £250:

Summary of exposures: 2 authorities owe £37.5 million (Authority A & B), 7 authorities owe £25million.

If authority A fails to pay a principal repayment, the following contributions will be required:

Authority B £6.6 million, remaining authorities £4.4million

Should Authority B fail to pay the contribution, the remaining authorities will be asked to contribute an additional £0.9million, i.e. a total contribution of £5.4 million

Portfolio of loans at £1 Billion

Summary of exposures: 2 authorities owe £125 million (Authority A & B), 7 authorities owe £107million

If authority A fails to pay a principal repayment, the following contributions will be required:

Authority B £17.9 million, remaining authorities £15.3million

Should Authority B fail to pay the contribution, the remaining authorities will be asked to contribute an additional £2.6million, i.e. a total of £17.9 million

Portfolio of loans at £2 Billion

Summary of exposures: 2 authorities owe £250 million (Authority A & B), 7 authorities owe £210million

If authority A fails to pay a principal repayment, the following contributions will be required:

Authority B £36.3million, remaining authorities £30.5million

Should Authority B fail to pay the contribution, the remaining authorities will be asked to contribute an additional £5.2million, i.e. a total of £35.7million

Note: These examples are illustrative. The UK MBA would expect the level of diversification, as the portfolio expands, to increase rather than effectively remain static.

Standard confirmation of LA's authority to borrow from UK MBA and execute a Guarantee

To: UK Municipal Bonds Agency PLC
[*Address*]

Date: [●]

Dear Sirs,

Certificate of Approval - UK Municipal Bonds Agency PLC (the **Company**)

With reference to the Framework Agreement [to be entered into / dated [*insert date*]] between the Company and various UK local authorities and as annexed hereto as Annex 1 (the **Framework Agreement**) and the form of guarantee attached as Schedule 2 to the Framework Agreement (the **Guarantee**), we hereby confirm that:

(i) the Authority has the necessary power to enable it to enter into the Framework Agreement and the Guarantee, and perform its obligations thereunder;

(ii) the Authority has approved the entering into of the Framework Agreement and the Guarantee; and

(iii) all necessary authorisations have been obtained, and all appropriate and applicable decision-making procedures have been followed and completed, to enable it to enter into this Agreement and the Guarantee.

[Attached hereto / Available at the weblinks specified below] are copies of documentation required to evidence the chain of authority from the council to the relevant signatories on behalf of such Authority, as follows:

[Annex 2 / [insert weblink]] - [*Set out all delegations of power from constitutional documents to signatory of the documents, referring to specific sections of documents where relevant. Such documents may include standing orders, Annual Treasury Management Strategy, delegations to committees, and should include minutes of meetings specifically approving the Framework Agreement and the Guarantee*]

Signed by: [*name*]

Chief Finance Officer (appointed pursuant to s151 of the Local Government Act 1972)

....

Signed by: [*name*]

Monitoring Officer (appointed pursuant to section 5 of the Local Government and Housing Act 1992, as amended by Schedule 5 paragraph 24 of the Local Government Act 2000)

....

Standard confirmation of LA's authority to borrow from UK MBA and execute a Guarantee

To: UK Municipal Bonds Agency PLC
[*Address*]

Date: [●]

Dear Sirs,

Certificate of Approval - UK Municipal Bonds Agency PLC (the **Company**)

With reference to the Framework Agreement [to be entered into / dated [*insert date*]] between the Company and various UK local authorities and as annexed hereto as Annex 1 (the **Framework Agreement**) and the form of guarantee attached as Schedule 2 to the Framework Agreement (the **Guarantee**), we hereby confirm that:

(i) the Authority has the necessary power to enable it to enter into the Framework Agreement and the Guarantee, and perform its obligations thereunder;

(ii) the Authority has approved the entering into of the Framework Agreement and the Guarantee; and

(iii) all necessary authorisations have been obtained, and all appropriate and applicable decision-making procedures have been followed and completed, to enable it to enter into this Agreement and the Guarantee.

[Attached hereto / Available at the weblinks specified below] are copies of documentation required to evidence the chain of authority from the council to the relevant signatories on behalf of such Authority, as follows:

[Annex 2 / [insert weblink]] - [*Set out all delegations of power from constitutional documents to signatory of the documents, referring to specific sections of documents where relevant. Such documents may include standing orders, Annual Treasury Management Strategy, delegations to committees, and should include minutes of meetings specifically approving the Framework Agreement and the Guarantee*]

Signed by: [*name*]

Chief Finance Officer (appointed pursuant to s151 of the Local Government Act 1972)

....

Signed by: [*name*]

Monitoring Officer (appointed pursuant to section 5 of the Local Government and Housing Act 1992, as amended by Schedule 5 paragraph 24 of the Local Government Act 2000)

....

Audit and Governance Committee
Meeting to be held on Monday, 26 September 2016

Electoral Division affected:
(All Divisions);

The County Council's Treasury Management Strategy 2016/17

Contact for further information:
Neil Kissock, Tel: 01772 536154, Director of Financial Resources,
Neil.Kissock@lancashire.gov.uk

Executive Summary

Recent economic uncertainty following the referendum vote to leave the European Union has resulted in the credit agencies downgrading the UK sovereign rating. In view of the recent change and in anticipation of any future reductions the County Council's Treasury Management Policy has been reviewed.

The economic position and low interest rates also requires further consideration for the fixing of long term debt and this report covers the options including the potential use of the Municipal Bond Agency (MBA). This report allows further opportunity to consider the risks associated with the MBA in response to a resolution from County Council.

Recommendation

The Committee is recommended to:

- Approve the changes to the Treasury Management Strategy, as set out in the report, to allow for changes in the UK sovereign credit rating following the referendum vote to leave the European Union; and

- Recommend Full Council to agree that the County Council enters into the UK MBA framework agreement as set out in the report.

Background and Advice

The Council's investment priorities are:

(a) The security of capital, and
(b) The liquidity of its investments

To meet the investment priorities the County Council requires very high credit ratings for an organisation to be considered as a suitable counterparty. Although the County Council does not rely solely on the credit ratings in making its investment decisions

Lancashire County Council

they do form an important part of the decision making process and the Strategy approved by the County Council in February included the following:

For short term lending of up to 1 year that the short term ratings from the ratings agencies be used and that a counter-party must have a minimum of:

Moody's P1 S&P A1 Fitch F1

Short term ratings were specifically created by the agencies for money market investors as they reflect specifically the liquidity positions of the institutions concerned.

For medium term investments in the form of tradeable bonds or certificates of Deposit (1yr to 5yrs, where immediate liquidation can be demonstrated), a blended average of the ratings will be taken (averaging across all available ratings), with a minimum of:

Long term AA3/AA-, and
Short term P1/F1+/A1+

For longer term investments (5yrs and above) in the form of tradeable bonds where immediate liquidation can be demonstrated, a blended average of the ratings will be taken, with a minimum of:

Long term AA2/AA
Short term P1/A1+/F1+

The minimum sovereign rating for investment is AA-.

Following the referendum vote to leave the European Union the rating agencies have reviewed the United Kingdom's sovereign ratings. Fitch has downgraded the United Kingdom’s sovereign rating by one notch to AA from AA+, and Standard & Poor’s has downgraded their corresponding rating by two notches to AA from AAA, following the referendum vote to leave the European Union. The outlook from both agencies is negative. Moody's have placed the UK on negative outlook.

Although the current ratings still fall within the current strategy it is not impossible that there will be further downgrades which would result in investments in the UK government Gilts, Treasury Bonds and bodies guaranteed by the UK Government falling outside the Treasury Management policy. This is not a desirable, or given the level of investment in Gilts, a sustainable position. Even if there is a further reduction in the credit rating of the UK the UK Government still represents a safe investment. The government has never defaulted on its payments and as an ultimate solution the Government could prevent insolvency by *printing money*. Therefore it is proposed that the AA- minimum sovereign rating is not applied to the UK. However, given that this is theoretically increasing risk within the portfolio it is proposed that limits on the holdings by maturity is introduced as follows:

	£m
Maximum 1 year to maturity	500
Maximum maturity up to 5 years	300
Maximum maturity up to 10 years	250
Over 10 years	250

Within the Treasury Management policy is provision for investments to be made with UK local authorities (including Transport for London). The limits are £100m for an individual transaction, £500m for the category as a whole and investment could be for up to 50 years. Currently, the strategy is based on local authorities having the same credit worthiness as the UK government on the assumption that government would provide support for any authority which ran into financial difficulties. Given the current financial uncertainty and potential changes to local government funding with central government grant being phased out this assumption needs to be reviewed. Where local authorities do have individual credit ratings these have recently been reduced. For example on 30 June Standard and Poor issued the following ratings:

Greater London Authority
Long-term rating Downgraded to AA from AA+
Short-term rating Affirmed at A-1+
Outlook Revised to negative from stable

Royal Borough of Kensington & Chelsea
Long-term rating Downgraded to AA from AAA
Short-term rating Affirmed at A-1+
Outlook Remains negative

Transport for London
Long-term rating Downgraded to AA from AA+
Short-term rating Affirmed at A-1+
Outlook Revised to negative from stable

Consideration has been given to reducing the risk associated with the County Council's investment with other local authorities. Arlingclose, the County Council's Treasury Management advisor, state they are "comfortable with clients making loans to UK local authorities for periods up to four years, subject to this meeting their approved strategy. For periods longer than four years we recommend that additional due diligence is undertaken prior to a loan being made." On this basis it is proposed that the investments to local authorities are limited as follows:

	Maximum individual investment (£m)	Maximum total investment (£m)	Maximum period
Up to 4 years	20	250	4 years
Over 4 years	20	100	10 years

The County Council will continue to invest in corporate bonds in line with its existing credit policy. These are liquid assets and are covered by corporate bond regulations and therefore are still seen as low risk.

Long Term Debt

The County Council has for the past several years undertaken a policy of taking short term debt to take advantage of the low interest rate environment. Therefore at 31 March 2016 the County Council had debt of some £719m which is due to mature within 5 years and which will need to be renewed to fund the Council's investment programme. Of this £392m is due to mature within 12 months.

Although it is expected that the interest rates will remain low for a further period the rates are at historically very low levels. Therefore to protect the County Council against future rate increases consideration should now be given to fix some of the debt on a long term basis. Traditionally, this would have been via a loan from the PWLB but it is anticipated that this is not the most cost effective method of securing the loan. It is possible that the monies can be raised on the market at a suitable rate but the Treasury Management policy also included approval in principle for:

- Preparations for borrowing through the Municipal Bond Agency
- the establishment of a Lancashire County Council Euro Medium Term Note (EMTN) programme to facilitate access to secure long term debt

These alternatives are re-considered here to determine if they are still appropriate forms of borrowing.

PWLB

The PWLB's function is to lend money from the National Loans Fund to local authorities and it is not anticipated that this function will not remain in the future. However, the PWLB rates are not the cheapest available and once a loan has been taken the early repayment charges can be prohibitive. They are therefore seen by the County Council as a lender of last resort. However, if circumstances are such that they provide the best option, the County Council will use this facility.

Market borrowing

The County Council can borrow from the market. There are sometimes opportunities to borrow from insurance companies or other pension funds. The level of borrowing at rates and timeframes which are considered desirable may however not always be available.

Lancashire County Council Euro Medium Term Note (EMTN)

A potential source of finance is the issuance of bonds. The standard mechanism for accessing public and private debt markets, through bond issuance, is through the creation of a "Euro Medium Term Note" (EMTN) programme. In July 2014 Cabinet approved the establishment and operation of a Lancashire County Council Euro Medium Term Note programme, which included the establishment of a company to facilitate the funding. A company has been established but to date it has not been seen as appropriate to pursue a bond issuance. To be effective it is estimated that the issuance would need to be a minimum of £250m.

In general to obtain the most advantageous rates a high credit rating is required. Currently the County Council is rated AA2 by Moody's but is on a negative outlook. As discussed above there is a potential for a further reduction in the UK's credit rating which is likely to result in the County Council's rating being reduced. In this instance, and in light of the reported financial position of the County Council the benefits of a bond issuance are uncertain. There could also be significant costs given the administration involved in taking this option forward. The financial markets are likely to take the view that the repayment of the bond would be a first call on future Council funding.

Municipal Bond Agency

The Municipal Bond Agency has been established to give local authorities access to borrowing at cheaper rates than those given by the PWLB. To have access to the borrowing facility the County Council must sign up to a framework agreement issued by the Agency. A report on the Bond Agency was submitted to the County Council on 21 July 2016 County Council resolved that the "Audit and Governance Committee be requested to examine the potential risks of the County Council entering into the Framework Agreement and the possible mitigation of those risks at its meeting on 26 September 2016 and a further report be presented to Full Council on 13 October 2016".

The key area of risk is the guarantees given by any local authority using the Agency. Firstly, all borrowers guarantee to make contribution loans to the Agency if it estimates it will be unable to repay bond investors for any reason. This may be because another local authority has failed to make a scheduled payment of interest or principal on a loan, or because the agency is insolvent, or simply because the agency has poor cash flow management and is unable to borrow elsewhere.

Another key risk is the joint and several nature of the guarantee (JSG) given by local authorities. This guarantee is given by all local authority borrowers directly to the bond investors, guaranteeing to make good any shortfall in payments from the agency to the investors when using the Agency. In effect this means that if the County Council took part in one of the bond issuances it would be guaranteeing the loan of other local authorities and therefore the County Council would potentially be liable if another authority defaulted. This guarantee could potentially extend for 75 years or more. One of the risks faced by the County Council is that over this time period the legislative framework and the role of the PWLB as a lender of last resort may differ from the position now.

Clearly, there is a risk involved with the Framework Agreement. The issue is whether or not the level of risk undertaken in entering the agreement is acceptable. The Bond Agency has taken steps to mitigate the risk and within the agreement it is required:

- 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;

- to maintain 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

The risk of a local authority defaulting on its debts must be considered. To date no local authority has defaulted on a loan. In addition, the major credit agencies consider that local authorities are highly regulated by the DCLG and the risk of lenders to local authorities not getting the principal and interest back is low. This must be caveated that these opinions are based on the current system and cannot predict future changes.

The UK MBA is obliged under the Framework Agreement to pursue any defaulting local authority for full recovery, using whatever means available.

In particular the UK MBA may:

- Declare such local authority's liabilities to the UK MBA to be immediately due and payable;
- Sue for, commence or join any legal or arbitration proceedings against the defaulting local authority;
- Exercise any rights of set off; or
- Apply to the High Court to have a receiver appointed under Section 13(5) of the Local Government Act 2013.

Should a default occur the contribution to cover the default would be in proportion to the non-defaulting loans. Therefore if the County Council agreed to use the MBA it could limit the amount it was to borrow from the MBA thereby potentially reducing its risk. Indeed, the MBA will have its own limits to ensure that proportionately it has not lent too much to a particular authority. This will limit both the risk to the MBA and to other authorities in case of default. Consequently, if it is agreed to enter the Framework Agreement it is not likely that the County Council would be looking to use it as a sole source of financing the debt that is maturing.

It is proposed that the County Council enters into the MBA framework agreement, with the terms of any loan being subject to the approval of the Council's S151 Officer and the Deputy Leader of the County Council, taking into consideration the potential liability being incurred from the guarantees, relative to the other borrowing options available to the Council at the time.

In order to protect the County Council against future interest rate increases, there are a limited number of options to secure the fixing of debt on a longer-term basis as set out in the report. The current economic uncertainty and financial position of the County Council significantly increases the risks around the EMTN. Signing up to the MBA framework agreement would allow the opportunity for this to be considered alongside the other more immediately accessible borrowing options available to the Council.

Consultations

N/A

Implications:

This item has the following implications, as indicated:

Risk management

If the Council does not sign up to the UK MBA framework agreement, the opportunity to secure long term borrowing below the PWLB rate may not be available under desirable terms.

Financial

It is not possible to say with any certainty what rates would be provided when the loans are taken. However, the expectation is that a direct EMTN issuance would be in the region of 0.25% lower than the PWLB rate. It is anticipated that the Bond Agency would also have rates around 0.25% lower than PWLB.

As an illustration, on a £50m loan over a loan period of 30 years, this would mean the saving would be £0.125m per annum and £3.750m in total over the length of the loan period.

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

Paper	Date	Contact/Tel
Borrowing from the Municipal Bond Agency	21 July 2016	Khadija Saeed, Head of Corporate Finance, 01772 536195

Reason for inclusion in Part II, if appropriate

N/A