SURREY COUNTY COUNCIL

CABINET

DATE: **14 JULY 2016**

REPORT OF: **MS DENISE LE GAL, CABINET MEMBER FOR BUSINESS SERVICES**

LEAD OFFICER: **SHEILA LITTLE, DIRECTOR OF FINANCE**

SUBJECT: **MUNICIPAL BOND AGENCY**

SUMMARY OF ISSUE:

The UK Municipal Bonds Agency (MBA) was established by the Local Government Association (LGA) and 56 local authorities, including Surrey County Council, for the purpose of enabling local authorities to borrow on more favourable interest rates than would otherwise be available to the council and to provide an alternative to the Public Works Loan Board (PWLB). The Council became an equity shareholder in the MBA during late 2015, following approval by the Shareholder Board to invest in the company for the amount of £450,000 equity under delegated authority.

In order to be able to borrow for the purposes of capital funding from the MBA, a local authority must first accept the terms of a Framework Agreement and agree to joint and several guarantee. This means that local authorities on a proportional basis will be guaranteeing all the existing and future finance obligations of the MBA.

This Cabinet report will assess the risks of entering into the Framework Agreement and providing the Guarantee for the purposes of borrowing from the company, as well as assessing the safeguards and protections that are in place.

RECOMMENDATIONS:

It is recommended that Cabinet approves:

1. entry into the Municipal Bond Agency Framework Agreement and Guarantee; and delegates authority to the Director of Finance and the Director of Legal, Democratic and Cultural Services to execute the Framework Agreement and Guarantee together with associated legal documentation;

2. delegate borrowing decisions to the Director of Finance in consultation with the Cabinet Member for Business Services .

REASON FOR RECOMMENDATIONS:

It is anticipated that the Municipal Bond Agency will provide the council with an alternative source of borrowing capital funds at more favourable interest rates than those available from the PWLB.

The recently revised Treasury Management Strategy 2016/17 means that there is no immediate need to borrow from the Municipal Bond Agency. Until the Council borrows, there is no financial risk to the Council in joining the Municipal Bond Agency Framework and Guarantee. If the current interest rate situation alters, the Municipal Bond Agency option could be an attractive borrowing option.

DETAILS:

Background

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

2. 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 seven non-executives and three executives. In addition, the Board will have the two sub-committees, chaired by independent non-executives.

3. The Council became a shareholder in the MBA during 2015-16, following consideration by the council's Shareholder Board and invested £450,000 equity under delegated authority. In total, the MBA has raised over £6m from 56 local authorities and the LGA.

4. The MBA has every prospect of offering a cheaper alternative to the PWLB. Other options include commercial loans from banks and LOBO loans (lender option borrower option with the PWLB traditionally regarded as the 'lender of last resort' i.e., a reliable platform for borrowing, offering ease of entry and administration. The pros and cons of each source of borrowing are regularly assessed by officers when funding decisions are being considered, and also at the time of the drafting of the annual treasury management strategy.

5. In order to be able to borrow from the MBA, a local authority must accept the terms and conditions 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 jointly with other local authorities who are signed up to the Framework Agreement.

6. Over the past six months, a working group of English local authorities (advised by law firm Allen & Overy) has been reviewing the Framework Agreement and Schedules provided by the MBA and their legal advisors Clifford Chance. Counsel opinion was also sought by the working group and Allen & Overy as to whether local authorities could lawfully enter into the Framework Agreement and Guarantee and borrow from the Agency.

7. 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.

Overview of the MBA

8. 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 an efficient and cost effective provider of capital finance. The MBA will borrow money from a variety of third parties, including local authorities and will issue bonds. It will then lend on a matched basis to UK local authorities.

9. 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 sovereign level 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 its 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.

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

MBA's Client Base

11. 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.

12. In terms of the current client base, it is pertinent to query if this can be changed. It could be changed if the Government chose to legislate to grant or revoke the power; and a court could limit or extend local authority powers, although with courts it is usually the limiting of power. What will not change is that for any foreseeable time in the future, the Agency will only lend long term to a local authority that can give a guarantee.

13. 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

14. 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 details 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 conditions.

Expected MBA Lending Timeline

15. 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 robust approval processes and the volume of demand for financing builds. On the signing of 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.

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

Pricing of the MBA's Loans

17. The MBA will operate a transparent pricing structure. The MBA will charge a margin over its underlying borrowing costs to borrowing local authorities:

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

18. The MBA may adjust these pricing 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. Therefore, for example, a transaction fee of £50,000 will be charged on a £10m loan compared to £3,500 charged by the PWLB.

Worked Example of Savings on a Loan

19. It is envisaged that borrowing from the Agency (as opposed to the PWLB) will result in a lower interest rate achieved (expected to be a net 15 basis points lower). The Council's estimated capital funding requirement in 2016/21 is estimated at £184m. Therefore, if the Council funded this by means of new borrowing, by utilising the MBA instead of the PWLB, the annual saving achievable would be £184m x 0.15% = £276,000 by 2020/21.

Prepayment

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

Public Works Loans Board

21. The PWLB is still a valid source of long term borrowing for local authorities. It should be noted that a Government consultation is underway that will transfer the auspices of the PWLB to HM Treasury.

CONSULTATION:

22. Senior management and the Cabinet Member for Business Services have been consulted in the preparation of this report.

RISK MANAGEMENT AND IMPLICATIONS:

Approach to Credit Assessment of Local Authorities

23. Prior to approving any loans, the MBA will carry out a robust credit review of each borrowing local authority. The MBA has developed proprietary credit scoring models based on similar methodologies to the main rating 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 standalone basis from the MBA.

Key Elements of the Framework Agreement

24. The guarantee required is 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 the Council give notice to withdraw from the guarantee, including repaying all outstanding borrowings, it will continue to guarantee all the borrowing of the MBA which is outstanding at that point in time from the period of its guarantee being in place until the debts run off.

25. The Framework Agreement mitigates the risk of a call on the joint and several guarantee. It achieves this by requiring the MBA to carry out certain processes, e.g., credit checks, and not to lend money to local authorities which it believes do not pass the credit assessment. It requires 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, and it includes requirement for notification in the event that a local authority will have difficulty in meeting its payment obligations.

26. 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 a local authority does not meet its obligation to the MBA on a timely basis, the MBA is required to ask authorities to make a contribution 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 plus interest from the defaulting local authority on a timely basis.

Default by a Local Authority

27. No principal local authority has ever defaulted on any loan (from the PWLB, a bank or any other lending institution). The statutory and prudential framework under which UK local authorities operate is amongst the strongest in the world. Any lender to a local authority has protection, under statute, by way of a charge on the revenue of that local authority. The unwillingness of a local authority to stain its reputation should result in the likelihood of a default event to be extremely low.

Risks and Safeguards of Entry into Framework Agreement

28. 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 into 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.

29. 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 (albeit pro rata with other lenders) 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.

30. However, the risks associated with the Guarantees are mitigated by the contribution arrangements mechanism. The Framework Agreement is 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.

31. 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 enrolling local authorities (and frequent checks post enrolment), 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.

32. 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 its guarantee without the protection that the contribution arrangements provide.

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

- The contractual obligations upon the MBA to undertake an initial and then at least annual credit assessments of each local authority;
- 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.

34. In addition to the above, the statutory and prudential framework under which local authorities operate should provide some reassurance as to the financial standing of the local government sector (and as such the unlikelihood of a local authority defaulting on its loans):

- 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;
- Each local authority’s Section 151 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.

35. Significantly the MBA has clarified that there can be no liability concerning both the Joint & Several Guarantee and the contribution arrangements unless the Council takes out a loan. In this context, if a local authority did make a decision to default on a loan, it is envisaged that a formal declaration to the Agency (and to the industry in general) would be made, and the Agency’s plan on recovery from guarantors would be implemented. Liability of the Council in the event of a default would only be only invoked if the Council took

out a loan and the liability would be shared pro rata with the other local authorities.

Financial and Value for Money Implications

36. The MBA offers the Council an alternative source of borrowing capital funds at a more favourable interest rate than the PWLB. Balanced against the VFM benefit is a degree of risk concerning the possible default of local authority counterparties as set out in the report.

37. The main risk arises from the council (in partnership with other local authority guarantors) being required to guarantee a defaulting local authority's loan repayment. This risk is mitigated by the MBA's robust credit reviews of borrowing local authorities and the achievement of a minimum credit rating. The fact that no local authority has ever defaulted along with the reputational risk that would result if such a default ever took place stands in favour of the current perception of an extremely small likelihood of a local authority default ever happening.

38. The mitigating procedures set up to minimise the risk level against guarantors are clearly laid out in the Risk section of this report. Moreover, the statutory and prudential framework under which local authorities operate will also alleviate the risk of a local authority default.

39. Ultimately, this is an instance where the pros/benefits and cons/risks of participating in this facility need to be carefully weighed up and considered. On the pros/benefits side of the equation, the MBA could offer a cheaper source of borrowing that could result in savings to the Council's future funding of its capital expenditure. On the cons/risks side of the equation, what needs to be carefully understood is the real possibility of the county council being called in to stand as a guarantor for a defaulting local authority into the future. This possibility needs to be carefully considered, however remote the probability of it ever happening.

40. This is a decision for Cabinet in terms of the Council's support of a company that has been created with the best intentions of providing an alternative means of long term capital funding but, at the same time, being mindful of the risks of future default, a possible event that may occur long into the future.

Section 151 Officer Commentary

41. The Director of Finance recognises the benefits of lower cost long term borrowing that will accrue to UK local authorities, but is also mindful of the long term risks associated with offering a joint and several guarantee to those local authorities that might default in the future. Having carefully considered the balance of the benefits of lower cost loans and the risks of bearing a proportion of costs of possible future default, the Director of Finance considers that it is not unreasonable to support the council in entering into the Framework Agreement, Guarantee and associated legal documentation, and that separate consideration of the risks will be given ahead of any decision to enter into a loan from the Agency.

Legal Implications – Monitoring Officer

42. Due to the innovative nature of the arrangement, an opinion was sought on behalf of all local authorities that may wish to take part in the MBA's operations. Jonathan Swift QC confirmed that, in his view, entry into the Framework Agreement and execution of the Guarantee would fall within the ambit of the general power of competence under the Localism Act 2011.

43. Leading Counsel also gave very clear advice on both the requirement for Councils to take reasonable decisions, and for them to be able to show that they have exercised their powers consistent with their fiduciary obligation to local taxpayers. Cabinet should therefore make an assessment of both the potential advantages and disadvantages of the Framework Agreement.

44. In doing this they will of, course, wish to be able to evaluate the extent to which the Council will benefit from better borrowing terms, taking into account both its likely borrowing requirements over the period of the agreement and the specific financial position of the Council, both now and in relation to the potentially very significant and long-term obligations placed upon it by entering into this arrangement.

Equalities and Diversity

45. There are no equality or diversity issues arising from entering into the framework agreement.

WHAT HAPPENS NEXT:

1. Approval by Cabinet of the Framework agreement.

2. Signed documentation returned to the MBA.

3. MBA issues first bond and lends to first local authority borrowers (timing still to be decided by the MBA on the issuance of the first bond).

4. Decisions on loans are delegated to the Director of Finance and the Cabinet Member for Business Services in accordance with the delegation powers listed in the Treasury Management Strategy 2016/17.

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Annexes:
None

Sources/background papers:
MBA Framework Agreement

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