CAPITA

Asset Services

Treasury solutions

Review of Municipal Bonds Agency – Revised Business Case Summary

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1. Background

In recent days, many clients will have been contacted by the Municipal Bonds Agency with a view to determining whether their authority may wish to express an interest in participating in a new cash lending facility. This facility will compete directly with other sources of funding, including that offered by the Public Works Loan Board. Expressions of interest have been sought in respect of either borrowing from this facility at a later date, or providing initial capital for the venture.

Capita Asset Services welcomes this potential new lending facility, but we are also aware that there are several additional areas which need to be addressed as part a comprehensive due diligence process before we can provide a definitive view.

2. Revised Business Case Summary

On 20th March, the Municipal Bonds Agency circulated a Revised Business Case Summary. We have reviewed the content of this document and have the following comments to make which we hope are both helpful to potential participants and the Bonds Agency itself.

Public interest case

Para 1 – Although the Municipal Bonds Agency would be potentially injecting new competition into the loans market, interest rates are set by the market participants (including banks, fund managers, pension fund managers etc) and the Agency may, therefore, have less control or influence over offered rates than it anticipates.

Local Authority and investor demand

Para 4 – There is an assumption that significant refinancing of existing loans portfolios will occur over the next three years, but depending on the speed of the recovery of the UK economy, there may actually be a propensity for authorities to further internally borrow if both resources permit and the cost of carry remains high (the differential between borrowing and investment rates). This of itself is a risk to the Agency's proposed business plan. In addition, as discussed at the recent round of Capita Asset Services seminars, there are a reasonable amount of authorities with a declining Capital Financing Requirement profile, which argues against any long-term funding being taken on board in the near-term.

Para 5 – An initial saving of 0.05% in interest payments is referred to, compared to the PWLB Certainty Rate, but this assumption is based on the success of the AA rated Transport for London issue. This organisation is one of the largest and best known participants in the public sector bond market. The Agency states that it will seek to gain a AAA rating but one of the criterion proposed by the Agency for moving towards this objective is the holding of 3%-5% risk capital. The question is, who is going to provide that capital and what interest would they anticipate receiving for their support and how are those costs to be recovered? It may also be difficult to get a AAA rating as the UK Government has been cut to AA+. It has been suggested that the capital will come from the lenders: for example, for £100m a council would borrow £105m, leaving £5m with the Agency. However, this would appear to have the effect of pushing the loan rate up as, for instance, a 4% coupon would in reality be 4.20% with this additional funding approach.

Para 6 – There is a reference to a “new issue premium” in the first year or two. Which “early joiner” authorities would voluntarily pay a higher interest rate on new borrowing than is offered by the PWLB. Could this lead to value-for-money audit issues?

Joint and several guarantee

Para 7 – There is reference to a “joint and several guarantee”. We would be interested to know whether there is Counsel’s opinion supporting this proposal from a legal standpoint and also whether the market view of this proposal would really support the supposition that another 0.25% reduction in interest rates would follow.

Para 8 – There is a reference to the Agency’s credit processes adding weight to the joint and several liability guarantee. What are the processes that are referred to?

Operating model and capital structure

Para 9 – The crucial point here is how flexible can the Agency be in respect of the bond maturity profiles and how will it ensure that its bonds are what its potential customers want in respect of size, duration and interest rate given the volatility of the markets intra-year? Will 30 or 40 borrowers all want the same monies for the same periods?

Para 10 – There is a lack of detail as to how the statement ”the shareholding structure would have limits on individual level of control and give a fair return to initial shareholders for risk taking” would operate in practice.

Para 11 – The proposal for a proportion of any loan being taken out by an authority being retained by the Agency suggests close scrutiny needs to be paid to the net interest savings calculations quoted by the Agency.

Timeline

Para 12 – The assertion that authorities base their borrowing on a March/April peak, and that any bond issue would reflect this profile, is somewhat outdated given authorities now have to contend with a low interest rate environment where the “normal” Bank Rate may not. be much greater than 3% in the coming years. This backdrop could potentially undermine the attractiveness of longer dated bond durations.

Risk

Para 15 – Is it an attractive investment? In CAS’s view, now is not the right time in the interest rate cycle to be lending long-term. This is based on various interest rate forecasts that long-term rates will increase over the medium to longer term. Also, following on from para 5, rates could and often do move by more than 0.05% in any one day, so the “savings” differential could be wiped out quite quickly, even before the overall costs of the bond are taken into consideration.

In addition, will the UK Government be happy that a competitor to the PWLB has emerged – one only has to look at the HRA self-financing reform process as an example of how the Treasury has the immediate ability to price PWLB loans to be lower than those offered by the market. A comparison to the Nordic approach, whilst interesting, does not help in clarifying the UK Government's competitive intentions in this respect.

We hope that you find the above a useful starting point for your own internal review processes, and please feel free to speak to your Client Relationship Manager if you wish to discuss any of the aforementioned points in more detail. We do believe that it is a good development, however there are a number of issues which need to be resolved.

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