A New Dawn for Municipal Financing Instruments?

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Summary: The Autumn Statement gave further support for regional investment in housing and infrastructure particularly through the creation of a new National Productivity Investment Fund. Local authorities continue themselves to invest in infrastructure through borrowing and optimising their assets. The latter has been the subject of previous articles and therefore this article concentrates on available sources of finance, current trends and the statutory intricacies which lenders/investors ought to be aware of.

The Autumn statement identified raising productivity as the central long term economic challenge facing the UK and will be a key area of focus for the Government's soon to be published Industrial Strategy. The Autumn Statement also announced a National Productivity Investment Fund (NPIF) to be targeted at four areas critical to improving productivity namely, housing, transport, digital communication and research and development. The NPIF will be new Government borrowing providing £23 billion of spending between 2017–2018 and 2021–2022. The new investment will support projects that demonstrate a clear and strong contribution to economic growth.

Background

A significant part of the NPIF infrastructure investment (particularly that for housing and transport) is likely to be secured directly or indirectly by Local Government. City Deals, Growth Deals and Devolution Deals have seen enhanced funding packages made available and devolved to local government to secure transport, housing and regeneration and economic development. The NPIF will provide additional funding and local government for its part needs to consider the "municipal financing instruments" available to it to work alongside the NPIF to increase infrastructure investment even further. Such "municipal financing instruments" may go beyond their traditional sources of finance and, as such, those capable of and contemplating lending to local authorities ought to consider a few intricacies, as will be explained.

Local authorities in England, Wales and Scotland have traditionally raised funds for infrastructure investment from the Public Works Loan Board (PWLB), a statutory body operating within the UK Debt Management Office. However, the 2010 Autumn Statement increased PWLB rates from 0.15% over gilts to 1% over gilts, greatly increasing the cost of new borrowing and re-financing. However, there are concession rates of 80 basis points for PWLB Certainty Rate Loans (which most local authorities will be able to take advantage of) and 60 basis points for PWLB Project Rate Loans (for an infrastructure project nominated by a Local Enterprise Partnership).

Local authorities in recent years have undertaken borrowing from commercial banks. However, it is difficult for banks to compete with the PWLB as they face the cost of setting aside capital when lending to local authorities, which they do not have to do when lending to Government. When commercial bank lending has occurred, loans have almost entirely been

Lender Option Borrower Option (LOBO) loans (a long term loan with a lender option to increase the rate with a linked borrower option to repay the loan) with inherent refinancing risks and potential breakage costs for embedded swaps. Local authorities are generally looking to refinance their LOBO loans where a fixed rate cannot be negotiated.

There had been very little local authority capital markets activity since 1994, when Leicester and Salford Councils turned to the bond markets. However, since the increase in PWLB rates in 2010 local authorities have increasingly sought to avoid the political risk inherent in PWLB rates by identifying independent sources of funding in the London capital markets. The well-publicised UK Municipal Bonds Agency sponsored by the Local Government Association is seeking shortly to make its first capital markets issue, the funds from which will be on loan to English local authorities. In addition, Warrington BC has recently issued £150m of CPI Bonds and Aberdeen Council £370m of RPI bonds, both issues to fund infrastructure and wider regeneration. Prior to this the Greater London Authority issued £600m of bonds for Crossrail and more recently £200m of CPI bonds for the Northern Line Extension. Transport for London has also issued bonds in its own name and has its own £5bn Medium Term Note and £2bn Commercial Paper programmes.

Institutional Investor Opportunity

Capital markets issues by local authorities can achieve pricing to challenge PWLB rates. The UK Municipal Bonds Agency is also using the credit enhancing technique of making each local authority jointly and severally liable for each loan to achieve comparative pricing (joint and several liability also gives rise to listing advantages as the issue would fall within the local authority listing exemption and also avoids the need for separate credit ratings for each tranche). Commitment to joint and several liability is only available to local authorities in England (as a consequence of being enabled by the General Power of Competence in Section 1 of the Localism Act 2011 which applies only to local authorities in England). Institutional investors providing bi-lateral loans could also potentially become a niche source of finance providing competitive pricing in return for an indexed long term secure income stream can be achieved.

Statutory Safeguards

From a lender's or investor's perspective lending to local authorities should not be complex due to their financial standing, although there are intricacies (primarily arising from statute), which will need to be considered. There will be little or no need for financial covenants as statutory safeguards which underpin local authorities, and which will be explained, should give sufficient comfort to investors.

Local authorities are prevented from borrowing to fund day-to-day services under the Local Government Finance Act 1992 and the same Act also requires an authority's revenue budget to be balanced without the use of borrowing. Local authorities in England and Wales have the general wide-ranging power under the Local Government Act 2003 to borrow for any purpose relevant to their functions or for the prudent management of their financial affairs (there is a broadly similar power for Scotland in the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016). In doing so, authorities have a duty to determine annually and keep under review how much money they can afford to borrow. In complying with this duty, authorities must have regard to the Prudential Code for Capital Finance in Local Authorities (Prudential Code) published by CIPFA which contains requirements for borrowing to be prudent, affordable and sustainable.

Local Authorities must appoint a statutory Chief Finance Officer under Section 151 of the Local Government Act 1972 (and Section 95 of the Local Government (Scotland) Act 1973). CFO's in England and Wales have various statutory responsibilities in relation to financial management including a requirement to submit a report to the Council of the local authority if the CFO determines the authority cannot pay its bills as they fall due (Section 114 Local Government Finance Act 1988). Such a report triggers a freeze on expenditure. The CFO must also report on the adequacy of reserves and robustness of budget estimates (Section 25 of the Local Government Act 2003). Section 114 does not have an equivalent in Scotland-instead the requirement to set a balanced budget is established in Section 108(2) of the Local Government (Scotland) Act 1973 and Section

93(3) of the Local Government Finance Act 1992).

A local authority in England and Wales cannot mortgage or charge any of its assets as security for its borrowings (Section 13 of the Local Government Act 2003). Any such security given is unenforceable. However, all local authority borrowings are, by statute, charged indifferently on all of the revenues of the authority. All such security ranks equally without priority. Whilst technically it could face a situation where it is unable to pay its debts, when they fall due, a local authority is not subject to the Insolvency Act 1986 (as such is not a company as defined in paragraph 111 of Schedule B1 to the Insolvency Act 1986).

However, a local authority can be subject to the appointment of a receiver under Section 13(5) of the Local government Act 2003. Such a receiver may be appointed by the High Court upon the application of any person entitled to principal or interest in respect of local authority borrowing where the amount outstanding is at least £10,000 and remains unpaid for two months following a written demand. The High Court may appoint such a receiver on such terms and confer such powers as it thinks fit. These powers may include any powers which the local authority has in relation to collecting, receiving or recovering the revenues of the local authority, issuing levies or precepts or setting, collecting or recovering council tax.

There is a further express protection for persons lending to local authorities in England and Wales contained in Section 6 of the Local Government Act 2003. This provision provides that such a person is not bound to enquire whether the local authority has power to borrow the money and furthermore the lender is not prejudiced by the absence of such a power. As a consequence of this "safe harbour" provision a lender need not concern itself as to the purpose, prudence of affordability of the borrowing nor that procedural requirements have been complied with and the lender is not prejudiced even if the decision by the local authority to borrow is not within its powers.

There are similar provisions to those above for giving protection to lenders to Scottish local authorities. These provisions include self-imposed limits on borrowing (Regulation 6 of the Local Authority (Capital Finance and Accounting) (Scotland) Regulations 2016), security to comprise authority revenues (Regulation 7 of the 2016 Regulations) and "safe harbour" provision (Regulation 8 of the 2016 Regulations). Local authorities in Scotland in relation to insolvency are subject to the Bankruptcy (Scotland) Act 2016.

There are also statutory requirements on local authorities in England and Wales to set aside revenue to repay debt. A local authority must take a Minimum Revenue Provision ("MRP") to repay debt by virtue of the Local Authorities (Capital Finance and Accounting) (England) Regulations 2003. This means that a local authority must set aside cash via its revenue budget sufficient to ensure it can repay its debts.

Finally, local authorities have access to Government grant funding in addition to deriving revenue from council tax, business rates and when applicable business rate supplement (the latter financed Greater London Authority borrowing for Crossrail). Whilst the dynamics of Government grant funding are changing, self-financing is the medium term aim, the current system of business rates involving equalisation between local authorities with safety nets means there is less dependency (and risk) on the local economy. However, this may change with the proposed 100% business rate retention. There are other potential policy revenue drivers such as Enterprise Zones where 100% business rates can be retained for 25 years (this is being used by the GLA amongst other sources of revenue to fund GLA borrowing for the Northern Line extension). Other evidence of Government support is the availability of the PWLB as lender of last resort.

Contractual Safeguards

Whilst the statutory provisions outlined above will give comfort to lenders, to local authorities there will remain events which should trigger a mandatory prepayment and/or local authority default. Mandatory prepayment is likely to arise from it becoming unlawful for the local authority to perform any obligations under the bonds or loan agreement or a change in status occurring in relation to the local authority. A change in status whilst falling short of illegality will be such as to change the nature of the local authority as borrower. This most likely will be the local authority ceasing to be treated as a

local authority within the Local Government Act 2003.

Other circumstances could be contemplated giving rise to a mandatory prepayment such as the inability to, levy or receive council tax, non-domestic rates or business rate supplements, receive Government grant funding or raise funding from the PWLB. However, lenders need to consider the changing environment of local authority funding, for example, the Government has stated its aim to move towards local authority self-financing (without grant) and as such avoid inadvertently creating a default. Such events, if appropriate, are best tied to the specific local authority as opposed to local authorities generally and possibly also, if applicable, where the circumstance results in a rating downgrade. Other prepayment events for the local authority may include where it is requested to pay additional amounts under the tax gross up clause.

In addition to failure by the local authority to meet a payment and a breach which has not been remedied, other events of default are likely to include:

- the appointment of a receiver by the High Court in respect of the authority under section 13(5) of the Local Government Act 2003
- the dissolution of the local authority other than where is a statutory successor
- cross default in respect of other loans of the local authority.

Information Requirements

Lenders should also consider including information requirements which could give an early warning to them of a deterioration in the local authority's financial performance. Such requirements are likely to include:

- the CFO forecasting the authority being unable to pay debts when they fall due
- the issue by the CFO of a report under section 114 of the Local Government Finance Act 1988
- a failure to comply with the prudential borrowing regime established by Part 1 of the Local Government Act 2003
- a failure to set a balanced budget in accordance with Sections 31A and 42A of the Local Government Finance Act 1992
- the report by the CFO under section 25 of the Local Government Act 2003 stating budget estimates are not robust and/or reserves are inadequate and these matters are not remedied
- the local authority's external auditor issues a qualified opinion in relation to the local authority's accounts
- failure of the local authority to publish its accounts by the statutory deadline
- any change in status of the local authority
- any breach of representation or warranty by the local authority
- any litigation is commenced which is likely to have a material adverse effect on the governance of the authority or its assets and/or its ability to repay the loan.

Consideration could also be given as to whether the occurrence of one or more of these events should escalate to give rise to a mandatory prepayment or event of default.

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Getting in touch

If you would like to talk through your project or discuss solutions to your legal needs, please get in touch.

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