UK MUNICIPAL BONDS AGENCY

Operational Update

May 2020

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Section 1

THE INAUGURAL £350 MILLION BOND ISSUE

Bond Details

- The £350 million bond was issued on 5 March to fund a loan to Lancashire County Council:
  - 5-year Floating Rate Note (FRN)
  - Linked to SONIA (replacement for LIBOR)
  - Guaranteed by Lancashire; does not fall within the Agency’s proportional guarantee
  - First 5-year SONIA linked FRN issued by a UK entity

Savings

- Priced at 0.8 per cent over SONIA. Gross savings were:
  - 0.81 per cent over the PWLB 3-month variable certainty rate
  - 1.08 per cent over the PWLB fixed rate*

- Savings have increased over time. As of 11 May:
  - FRN interest rate currently 1.45 per cent below PWLB 3-month variable certainty rate
  - Issued today, saving would be 1.12 per cent over PWLB 3-month variable certainty rate

*Source: Barclays Capital

Section 2

BUSINESS CASE AND VALIDATION

The UKMBA’s Business Case

- Arguments for the UK Municipal Bonds Agency including sector independence were clear:
  - Protect councils from PWLB changes
  - Deliver savings
  - Provide fully transparent financing
  - Reduce risky and excessive borrowing
  - Tailor products to suit local authorities’ needs
  - Generate economies of scale

Validation

- What has happened and is happening:
  - PWLB rates increased; future uncertain
  - UKMBA has delivered savings
  - Complex products coming to the fore (again)
  - Several councils have excessive, risky borrowing
  - Pricing of many alternative loans is often poor and opaque; value for money unclear
  - With the 50-year Gilt rate at 0.45 per cent, the PWLB margin quadruples the cost of borrowing.

Section 3

FORTHCOMING MEDIUM AND LONG TERM BOND ISSUES

Three Maturities

- Discussions with potential borrowers have suggested demand is clustered in three maturities, all for fixed rate loans:
  - 10 years
  - 20 to 25 years
  - 40 to 45 years
- Agency needs clear demand in order to proceed with a particular bond issue.
- Specific maturities to be agreed with borrowers

What We Need

- This means:
  - At least £250 million demand for a given maturity
  - Confidence that authorities will participate, subject to rates being lower than those of the PWLB
  - Confidence can only be based on:
    - Commitments to participate in bonds
    - Approval of Framework Agreement
    - Asking the Agency to begin its credit process

Timing and Pricing

- Bonds will be placed within **8** weeks of benchmark demand being identified:
  - ➢ Moody's needs 6 weeks for its credit work on the Agency
  - ➢ Requires local authorities to meet deadlines e.g. signing of Framework Agreement
  - ➢ Timescales will shorten over time
- Pricing will depend on maturity. At today's rates:
  - ➢ c. Gilts +90bps at 10-years
  - ➢ c. Gilts +125bps at 45-years

PWLB Consultation

- Suggests reductions in PWLB rate, BUT:
  - ➢ Consultation states any reduction is subject to interest rates
  - ➢ Timing uncertain, if at all
  - ➢ Consultation events not taking place
  - ➢ Conditions may be unpalatable or unworkable
  - ➢ No commitment to restore rates to Gilts +80bps
  - ➢ IF control is important to HMT, further UKMBA issues will increase pressure and increase chances of a cut to PWLB rates

Section 4

OTHER PRODUCTS

Forward Rate Loans

- These loans will guarantee the interest rate a council pays on a loan from the Agency that is drawn down within 2 years:
  - Requested by councils from the outset
  - Used when a council needs future certainty regarding the cost of funding e.g. complex capital projects
  - Costs fully transparent for local authorities
  - Agency is partnering with an investment bank because it cannot enter into derivatives and loans must be back-to-back with funding

Short Term Loans

- The Agency will offer short term loans for up to one year maturity, funded by commercial paper:
  - Allows a council to receive funding while a bond is readied or it waits for a different maturity
  - No need to commit to a long term loan
  - Borrowers remain subject to Agency's credit process
  - No need to sign the Framework Agreement
  - Outside the proportional guarantee
  - Will be available from late June
  - Very short lending timescales: less than 2 weeks

Floating Rate Debt

- Can be offered within the proportional guarantee and on a standalone basis
  - Interest rate will be tied to SONIA
  - Proven to be cheaper than PWLB equivalent
  - Can price better than fixed rate debt – less risk for investors if interest rates rise
  - Ideal when interest rates are unlikely to rise
  - Treasury advisors consistently suggest debt portfolios have some variable rate debt

Standalone Loans

- Offered to any council able to borrow £250 million or more:
  - Outside proportional guarantee and Agency’s credit process
  - Requires the council to obtain a credit rating from one of Moody’s, Standard & Poor’s or Fitch
  - The council must guarantee the related bond issue
  - Available for any maturity; various repayment structures available; fixed or floating.

Section 5

THE PROPORTIONAL GUARANTEE

The Proportional Guarantee

- All pooled borrowers will guarantee all back-to-back borrowing by the Agency:
  - A council’s liability will be proportional to its share of the outstanding borrowing
  - Extends the principle underpinning the contributions mechanism into the guarantee structure
  - Not a joint and several guarantee i.e. no council or group of councils can be singled out to cover a default
  - Not irrevocable i.e. an authority that owes nothing is not a guarantor even if loans repaid “early”

Some Myths Debunked

- The proportional guarantee does not cover:
  - Running costs of the Agency
  - Debts owed to anyone other than the Agency
  - A default after an authority has repaid all its loans
- LBHF did not default on a loan:
  - The courts found that the council "writing" i.e. selling, derivatives not related to its treasury management needs was illegal.
  - LBHF accounted for two thirds of the UK swaps market

Credit Framework

- The Agency retains its credit process:
  - Rigorous, but light touch
  - Based on the methods used by Moody’s et al
  - All credit decisions ultimately approved by the Agency’s Board
  - Borrowers must achieve a score of “A” or higher; UK is “Aa” rated from Moody’s and “AA” by Standard & Poor’s (Fitch an exception at “AA-”)
  - No council guaranteed to pass the process

A QUICK RECAP

Key Points

- Agency has validated its business case
- Significant savings delivered for Lancashire County Council
- Three bond issues being readied: 10 years, 20-25 years and 40-45 years
- PWLB rate cuts not certain
- New products on offer; short term loans in near future
- Proportional guarantee less onerous than joint and several guarantee
- Credit Framework is still robust

Questions?