

The name is bond...

Traditional capital funding methods are proving risky. So why shouldn't local authorities be able to adopt the US model of municipal bonds, asks Chris Leslie

THE RECESSION HAS taken its toll on many communities, yet there has been a dearth of capital stimulus to counteract its effect. While the banking crisis has provoked significant intervention, there has been insufficient reform and ingenuity to tackle the crisis in public infrastructure finance.

Just when we should be kick-starting construction and employment in our towns and cities, the public sector seems unsure how best to finance vital projects. So as conventional capital options appear unsteady, we should look to US and European municipalities, where an entirely different approach – principally bond finance for local public works – offers a model whose time might have come here.

The notion that municipalities should freely raise resources directly from capital markets runs contrary to every policy

instinct drilled into our local authorities. Collective memory can barely cast back before the 1982 reforms when local debenture finance was supplanted by a central 'credit approvals' process as part of former Conservative prime minister Margaret Thatcher's attempt to take control of the national accounts. These annual capital 'allocations' emasculated local autonomy, but also instituted a reliance on low-cost lending available from the Treasury's rapidly dominant Public Works Loans Board.

In the calm of the 'non-inflationary constant expansion (Nice)' decade, a benign PWLB dishing out cheap finance to dependent localities seemed harmless enough. The more relaxed era of 'prudential borrowing' since 2004 even gave councils the impression that a limitless pot of money might be on tap as long as they had the (centrally determined) resources to service any borrowing.

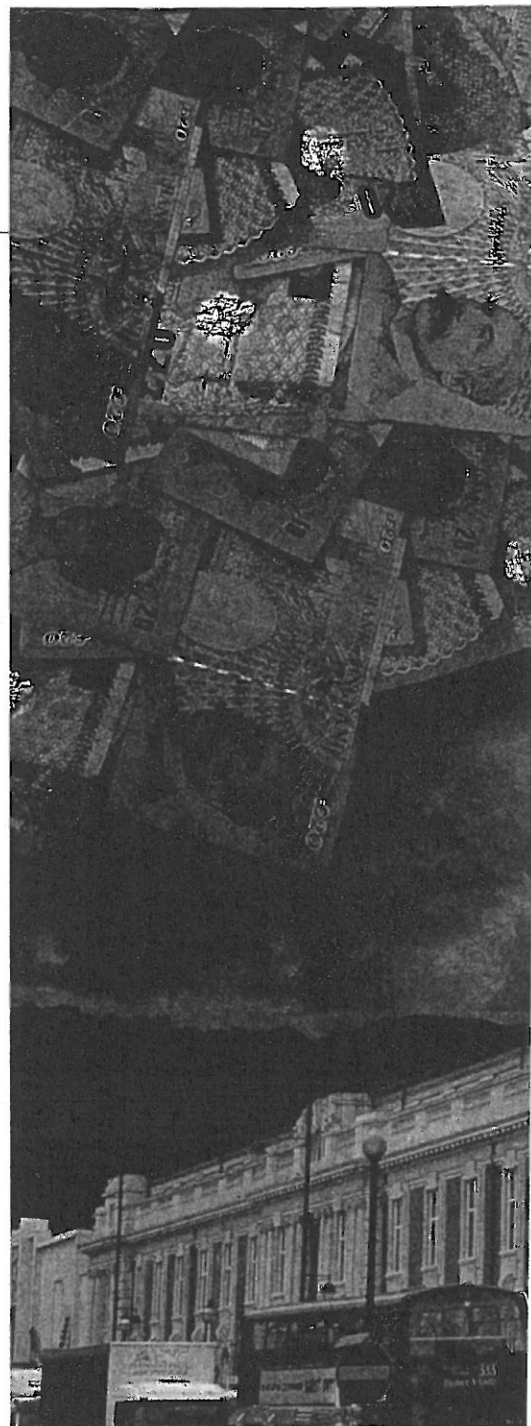
But that decade has now passed and we are entering a lean era where expenditure is to be reined in. Borrowing will be more tightly constrained, receipts controlled, grants curtailed and revenues cut back. Local authority finance directors should be worried that a future Treasury might suddenly change these prudential borrowing rules and cut the supply line.

Local authorities should be keen to take back control. By rediscovering project finance skills, councils could guard against a dangerous reliance on the PWLB as sole supplier. For the longer term, we should welcome a renewed connection between how a project is financed and how

it proceeds; rudimentary management theory but too often overlooked. The prize of stronger project leadership and the disciplines that come from an active relationship with the commercial market could improve management.

British politicians, still scratching their heads at the lacklustre performance of cumbersome national capital commissions, from IT to school building, should realise that the disconnect between finance and provision is a critical reason for so many of our problems. Treat the front line as though it is an immature child and no wonder it craves supervision and relinquishes responsibility.

Similarly, our local councillors and chief executives can find themselves spending more time studying Whitehall pronouncements than communicating with residents, businesses and the markets, because their



The time is right: town halls have discussed pooling treasury management activities

grants due to be halved from £44bn to £22bn by 2014 under current government plans, the prospects for traditional capital finance look distinctly pallid unless new routes are developed soon.

Yet there are stirrings afoot – with interest emerging in different approaches. Frustrated by the failures and volatility of the mainstream banks, several local authorities are already talking collectively about how to take more control by pooling treasury management activities.

There are real opportunities for the astute public service manager to anticipate this changing environment and enter deals with investors looking for solid and well-managed ventures. Institutional investors might be the bedrock, but ordinary retail investors – perhaps local residents keen to back worthy new facilities – could also be attracted by a 'Build Britain Bond' model, especially if accompanied by US-style tax relief.

A British municipal bond market is now a real prospect. Yes, a significant change in attitude would be needed by the Treasury to break the current dependency culture, but this is not unrealistic. The political commitment to localism is gaining momentum

as politicians realise the limitations of a command-and-control approach.

Labour must rejuvenate its credentials in public service investment and its manifesto will have to explain how. And the Conservatives say in their *Control shift* policy green paper that they are 'currently looking at ways to allow local authorities to promote and market local bonds to deliver privately-financed local projects, such as a new transport service or business development'.

In their case, the Tories prefer a revenue bond model, clearly indicating their desire for off-balance sheet alternatives to PFI. With both parties vying to show they favour an environment in which councils no longer need permission to act – including a Conservative commitment to a 'general power of competence' – the prospects for an end to central 'credit approval' processes look stronger. Change is undoubtedly coming and smart local authorities will prepare the ground now to achieve the twenty-first century aspirations of their residents.

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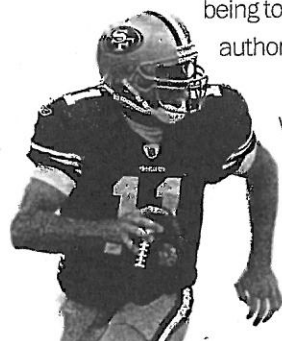
The US Muni-Bond Market

Most of the public works in the US are funded through the 'muni-bond' market, with an estimated £1.6trn of bonds and 50,000 issuing authorities, ranging from states as large as California or New York to tiny school district bodies. Sewers, pavements, libraries and bridges – all are paid for by the loans raised through these interest-bearing certificates, repaying the principal capital perhaps 30 or 40 years from issuance.

Although an array of hybrid bonds are issued, there are two broad categories: 'general obligation' bonds, secured against the general taxes levied on local residents; and revenue bonds, backed by specific income streams, typically user fees, and not subject to general voter approval. This latter form has grown in popularity, offering both political and balance sheet convenience to government.

Either way, municipal bonds are rated by credit agencies according to their risk (usually very low because defaults by public authorities are rare), the aim for the issuing authority being to achieve the lowest interest-servicing costs possible. Some public authorities issue bonds for general economic development.

San Francisco persuaded the 49ers American football team to stay with a specific municipal bond issue for a new stadium. There are sector markets for housing or public utilities and collective 'regional' markets. President Barack Obama's fiscal stimulus package gave multibillion-dollar subsidies to buyers and issuers of local 'Build America Bonds' under the American Recovery Act 2009.



MONTAGE: JOHN BOWLING/ PHOTO (LEFT): PA

success or failure is determined centrally rather than locally.

While our model of local democracy could cope with full council approval for most bond finance, there is much to be said for the US tradition of seeking voter approval for large-scale general obligation bond issues. It could add a healthy dynamic with taxpayers more involved in how new facilities are financed.

Of course, should a British bond market develop, it would be essential to learn the lessons from the US; there needs to be a transparent and competitive process and a careful regulation of underwriting to prevent local abuses and corruption.

The decade of the centrally mandated Private Finance Initiative has had its foundations shaken, already heavily propped up by Treasury and European Investment Bank subsidy. And with central capital