



28 September 2009

PWLB FIXED RATES: A CONSULTATION LETTER

1. Following the publication by the House of Commons¹ of a report into local authority investments, and a similar earlier report by the Audit Commission², the UK Debt Management Office, together with the Public Works Loan Board (PWLB) and HM Treasury, is reviewing the frequency with which fixed interest rates are set. This open letter seeks views on the practical and other considerations for stakeholders in PWLB rates being re-set regularly intraday with a view to DMO/PWLB being able to pass through in a more timely fashion the benefits achieved by central government in the wholesale funding markets.

BACKGROUND

2. The PWLB is an independent statutory body dating in its present form from 1875. It is headed by Commissioners, whose function is to consider loan applications from prescribed bodies and where loans are made to collect the repayments. Nowadays almost all loans are to local authorities only, for capital purposes. Since 2002 the secretariat of the PWLB has been a unit of the UK Debt Management Office (DMO), operating from its offices in the City. The Board charges fees on new advances according to a statutory scale.

3. Most applications are for fixed rate loans but variable rate loans are also available, with the interest rate being reset at intervals of one month, three or six months as agreed. Of three methods of repayment, maturity is the most popular, but loans amortised by the methods of annuity or EIP (equal instalments of principal) are also available.

4. The DMO sets the Board's rates of interest according to methodologies which have been agreed with HM Treasury and are designed to protect the interests of the National Loans Fund, which is the source of PWLB funds and into which repayments are made³. It is because the Board in effect on-lends central Government's own borrowings that rates are set with reference to the Government's cost of borrowing. The consequence of this is that local authorities can borrow at rates very close to those which the Government itself pays.

5. The Board's function is to provide capital finance to local authorities. It is not statutorily required to accept the early repayment of loans, although it exercises discretion in considering requests for prepayment provided that the loan has been running for at least a year and has at least a year to run. Where an early repayment is made, a premium or a rebate is paid equal to the net present value of future cash flows discounted according to the published rate schedule. Administrative fees are not charged on early repayments. The discretion to accept premature repayments means that while requests to pre-pay eligible loans will often be approved, PWLB is not set up, and cannot be considered, to be a regular and active counterparty to local authority treasury management. Indeed, the National Loans Fund (NLF), the government account that finances PWLB loans, does not itself pre-pay its liabilities and hence any decision to prepay a PWLB loan necessarily introduces a maturity mismatch between central government assets and liabilities.

¹ *Local Authority Investments*, the seventh report of the 2008-9 session by the House of Commons Committee for Communities & Local Government

² *Risk and return: English local authorities and the Icelandic banks*
(Released 26 March 2009)

³ s5 National Loans Act 1968

6. The National Loans Fund (NLF) is not permitted to lend at a loss. Accordingly, the interest rates charged on NLF loans, whether fixed or variable, must be at least as high as the notional rates at which the NLF could raise funds for a similar period. By analogy, when early repayments are accepted by PWLB the applicable discount rates must be no higher than those at which the NLF would be able to reinvest the cash for a similar period.

7. The current practice is for PWLB rates to be fixed from the start of each business day using par yields calculated from the previous day's closing gilt yield curve. These are mid-market references derived from the individual rates applicable to the sale and purchase of gilts in normal market size. The rate for an advance of a given maturity is determined from the maximum par yield for the relevant maturity bucket, while the early repayment rates are determined from the minimum par yield for the relevant maturity bucket.

8. From the time at which the rates are fixed until the time loans or repayments are agreed, market rates can have moved significantly. In order to prevent the NLF lending at rates that may have fallen below the prevailing market rates, or from accepting prepayment at rates that may have risen above the prevailing investment rates, spreads to reflect the daily volatility of yields are added to or subtracted from the relevant par yield. Spreads may differ over time and between maturities. Loan refinancings are treated as separable and independent loan and prepayment transactions.

9. The corollary of the approach to setting PWLB loan and prepayment rates is that the shorter the period between rates being fixed and the PWLB negotiating transactions with its customers, typically the lower will be the potential for market rates to have moved and the smaller the spread that will need to be applied. Were PWLB rates to be applied in real time, for example, rather than pre-fixed as currently, loan and pre-payment rates could be expected to gravitate towards market yields for gilt sales and repurchase. While the setting of loan and prepayment rates in real time may pose practical challenges both for DMO/PWLB and for local authorities, a compromise may be to set rates more frequently at fixed times during the business day.

ISSUE

10. Comments are invited on PWLB adopting scheduled intra-day changes to fixed rates. Rates could be set at start of business on the basis of market opening rates, so as to take account of overnight movements, and then again three or four times during the business day. It is provisionally envisaged that the times would be 9 a.m., 11 a.m., 1 p.m. and 3 p.m. Comments are invited on this proposal, on possible alternative times for re-determining rates and on re-setting rates at even more frequent intervals. Depending on the changes that might be adopted, it is anticipated that the differential between loan rates and pre-payment rates would diminish, particularly for longer maturities. The precise shapes of the interest rate curves would depend on market conditions. DMO/HMT would still reserve the right to make out-of-sequence intraday changes (albeit rarely) in the light of these conditions.

NEXT STEPS

11. Responses are invited on the proposal in paragraph 10 by **Friday 8 January 2010**. Please respond by e-mail to the PWLB's general in-box, pwlb@dmo.qsi.gov.uk. DMO/PWLB will announce its conclusions on the consultation as soon as possible after the end of the consultation period. It should be assumed that responses will be disclosable under the Freedom of Information Act 2000.

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