



# Investing Together

The case for a Local Authority Mutual Fund

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New Local Government Network (NLGN) is an independent think tank that seeks to transform public services, revitalise local political leadership and empower local communities. NLGN is publishing this report as part of its programme of research and innovative policy projects, which we hope will be of use to policy makers and practitioners. The views expressed are however those of the authors and not necessarily those of NLGN.

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## 1 *Introduction*

**This paper describes the opportunity that exists to create an English Local Authority Mutual Fund whose purpose would be to provide a safe vehicle for reserve deposits which in turn might be lent in support of English local authority regeneration or infrastructure capital schemes.**

Our survey of a wide range of local authority directors of finance reveals significant support for the initiative – over 80% - and we estimate that if this level of support were repeated across the country a fund of between £389million and £2.8billion might be a viable proposition, larger than the combined assets of the UK's credit union holdings at present. On the basis of these results, the New Local Government Network – together with local councils eager to progress the concept and other specialist partners – intends to work up an outline business case for the creation of England's first council mutual bank.

Until recently, little attention has been paid to the nature or potential of local authority financial reserves. For several decades the banking sector has provided adequate deposit facilities with the necessary flexibility sought by local councils in England, who have been content to trust their holdings in the hands of a financial services industry which – with the exception of the BCCI debacle in the 1990s – offered relatively strong protection.

However, the financial services hegemony was severely shaken in 2008 when the Icelandic banking system froze an estimated £1 billion of holdings from companies, authorities, charities and other public bodies in the UK. We should not underestimate the policy and political ramifications that have flown as a consequence of this predicament. The local authority sector has been forced to fundamentally reassess its attitude to risk and the stewardship role it plays on behalf of the council tax payer. Although it is highly likely that depositors will recover their funds, the reputational damage was felt not only by the ratings agencies who advised on the viability of Icelandic bank investments, but especially by local councils who bore the brunt of the media wrath in the autumn of 2008.

Just as councils were grappling with the consequences of the Iceland banking situation, it was becoming ever more apparent to council regeneration teams, transport engineers, planning departments and infrastructure managers across the public sector that the tap supplying a steady flow of available capital to fund their local projects was slowly beginning to turn off. The lack of trust in the interbank market is being felt in public-private partnership schemes where private finance is – at the very least – far more choosy of where it agrees to commit, if at all. Due diligence timescales are extending, investors are querying even the most basic public sector income stream covenants, and this at a time when PFI is already becoming less attractive because of the reversion to on-balance sheet treatment as a consequence of changes to the international accountancy rules. In short, local authorities are finding it harder to find available capital to continue their public investment plans – a fact borne out in our survey of local authority finance directors, 64% of whom predicted a greater than usual shortfall in capital finance for local projects over the coming three years.

The twin challenges of security of reserves and available capital finance mirror one another and an obvious opportunity presents itself for local authorities to change their reserves strategies, obtaining greater control and certainty over their holdings, while mutually supporting the prospects for improved public infrastructure here in this country.

The Icelandic crisis revealed that very substantial council reserves are held in random and uncoordinated funds worldwide, which could be better applied to more productive benefit here at home. Intuitively the case for a pooling of council reserves to be reinvested in projects yielding a modest but stable return would match the expectations of many authorities. With estimates of total council reserves of between £15-£20billion today, even a fraction of this sum invested in a cooperative manner could yield millions of pounds of capital, regardless of the state of the private interbank market's willingness to lend. And if local authorities were in the driving seat of such a fund, any returns or profits could be reinvested in the sector – a model attractive across both ends of the political spectrum.

Significant questions remain about how such a fund would operate, where the skill set would be found to ensure a high calibre of investment and regulatory compliance, and whether there could be a read across to other council fund

management activities such as the local government pension schemes. Nevertheless, the circumstances councils are facing should spur efforts towards new collective solutions. Out of the banking liquidity crisis may yet spring new ingenuity in the public sector – and a local authority mutual fund to apply a portion of reserves to the noble purpose of improved public facilities could be one such innovation.

## 2 *Survey results: Local authority reserves*

Between 28<sup>th</sup> November and 12<sup>th</sup> December 2008, the New Local Government Network surveyed 27 local authority directors of finance and council treasurers across England, in order to better understand the current reserves position and gauge interest in this proposal. 16% of the councils surveyed were affected directly by the Icelandic banking asset freeze, a proportion similar to that reported in the media at the time. On the questions of use of reserves and attitudes to a mutual fund, the results were extremely interesting.

A key question that must be addressed when considering the viability of a Local Authority Mutual Fund is whether they have sufficient levels of reserves to make pooling of them viable and worthwhile. It is also necessary to take into account the distribution of reserves both in terms of earmarked capital that may need to be withdrawn at short notice and unallocated reserves that can be invested on a more long term basis.

Local authorities were also surveyed as to their current distribution of reserves. This data, displayed below, will help in analysing both the viability of a Local Authority Mutual Fund and the form that it should take.

**Figure 1** What proportion of your gross budget is held in reserves?

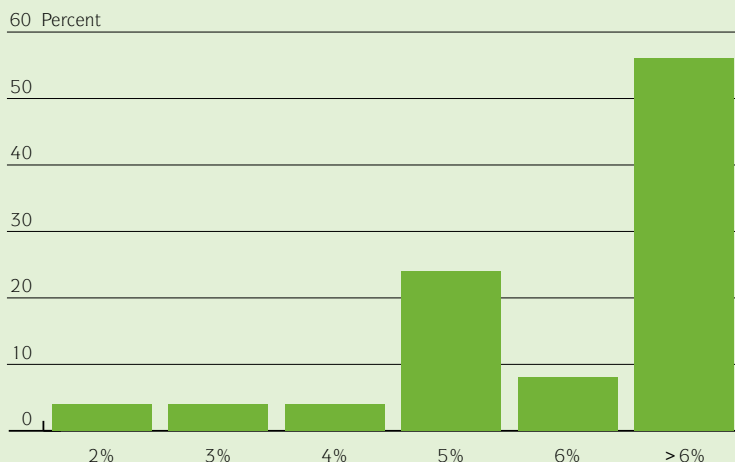
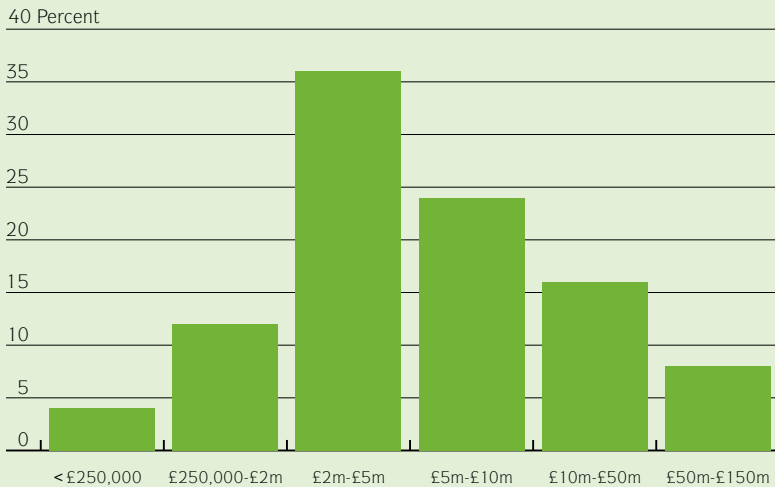
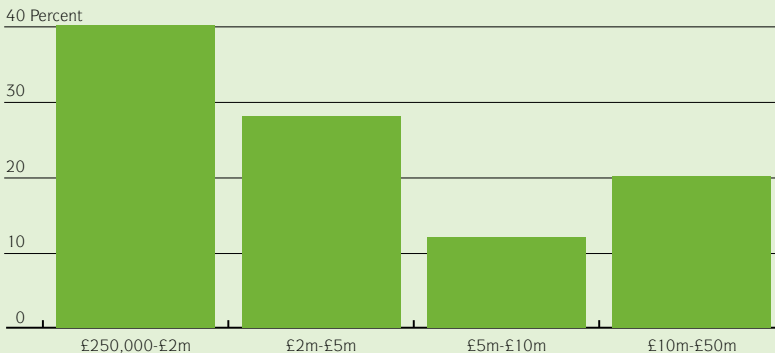


Figure 1 shows that the vast majority of local authorities, over 88%, have 5% or more of their gross budget held in reserves at any one time. Given that budgeted total net current expenditure by local authorities in England totalled £106.3bn in 2007-8<sup>1</sup> these sums are not insubstantial and if even a small portion of them could form the basis of a Local Authority Mutual Fund, a substantial holding could be established.

**Figure 2** What total earmarked reserve levels does your authority currently hold?



**Figure 3** What total unallocated reserve levels does your authority currently hold?



<sup>1</sup> <http://www.communities.gov.uk/publications/corporate/statistics/revenue200809budgetupdate>

Figures 2 and 3 give a breakdown of both the nominal level of reserves and their purpose. It is notable firstly that individual local authorities hold fairly large sums in reserves, with the majority holding over £4m at any given time. This matches well with the information in figure 1 as to the overall level of reserves.

The level of unallocated reserves is lower than the level of earmarked reserves for most authorities. This indicates that the majority of local authorities will require the ability to withdraw at least a proportion of their deposits at fairly short notice as it may be required to cover shortfalls in the service areas for which they are earmarked.

However the level of unallocated reserves is also substantial. Based on this data it is likely that a Local Authority Mutual Fund designed to act as a long term investment mechanism would attract funds, although from a narrower group of authorities and with a lower level of overall deposits than a more conventional bank deposit scheme would have.

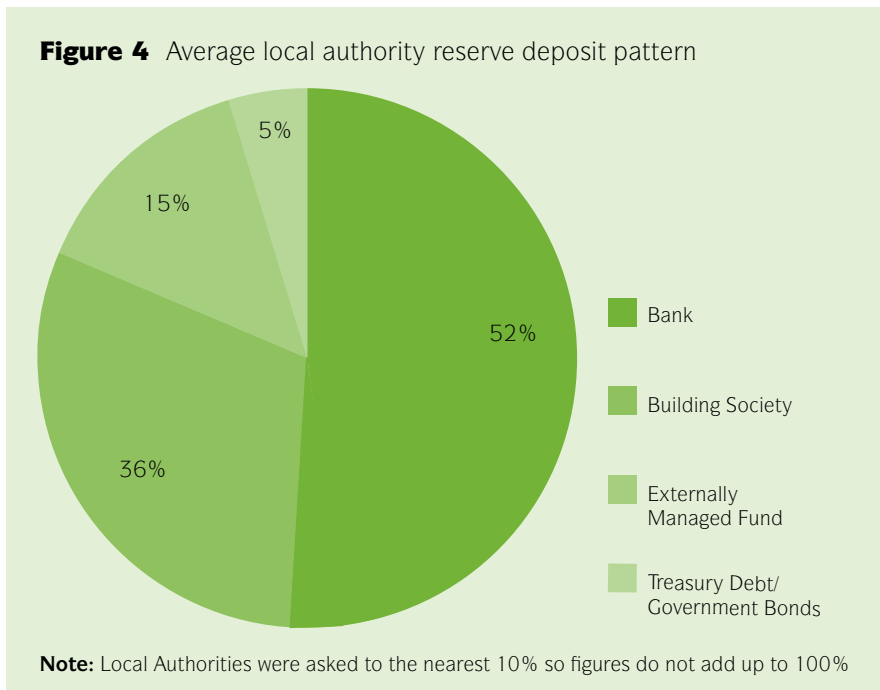


Figure 4 casts further light on both the requirements local authorities have for banking services and their overall risk profile for investment.

The vast majority of local authority reserve funds (88%) are held either in Banks (52%) or Building Societies (36%). This indicates a definite desire for liquid assets that can be easily accessed as and when the local authorities require them.

This proportion is surprisingly large given the relative level of reserves local authorities reported as earmarked for specific services.

This suggests that unallocated reserves are frequently held as conventional deposits rather than being deployed in more risky investments and may indicate risk-averse tendencies amongst financial directors. In the current economic climate it is possible that financial directors are, like many investors, limiting their risk exposure and so any offer that a Local Authority Mutual Fund might make as a safer haven for domestic infrastructure investment could have significant attractions.

Despite the dominance of bank and building society deposits there is also a clear trend towards using some reserves as speculative capital to generate future funds.

While 5% of reserves are held in Treasury Debt Management Office or Government Bonds both of which are long term, low return and notably safe assets, 15% of reserves are currently in externally managed funds which, depending on the specific details of the scheme, can provide greater exposure to risk but higher returns.

In the context of the Local Authority Mutual Fund this indicates that there is a clear market amongst local authorities for both long term secure deposits and speculative investment, but that the majority of reserves will need to be relatively accessible.

There are also clear signs of risk aversion amongst Finance Directors suggesting that the risk-profile of the Mutual Fund would have to be fairly low. This should not be difficult to ensure especially if the borrowers from the Mutual Fund are local authorities investing in infrastructure, regeneration or capital projects that will yield dependable returns over long periods of time. Consideration will also have to be given to the issue of whether more short term adjustment or smoothing loans will fit with this risk-profile.

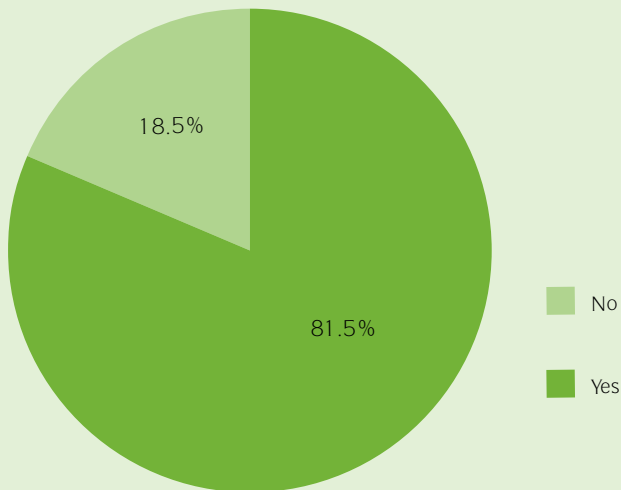
### 3 *Local authority opinions in principle*

**The creation of any form of Local Authority Mutual Fund would be dependent on the attitude of local authorities and their willingness to invest in a fund once it was established.**

Unanimous support amongst local authorities would not be necessary to the scheme provided that there were enough participating and contributing authorities to enable the scheme to both self-sustaining and a worthwhile investment for participants.

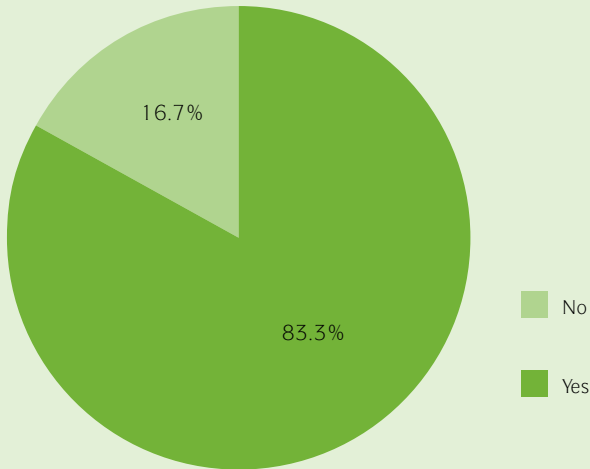
The survey questioned local authorities as to their opinion, in principle, of the idea of the creation of a Local Authority Mutual Fund and their attitudes towards depositing or borrowing from the Fund if it was created.

**Figure 5** In principle would you support the establishment of a Local Authority Mutual Fund on an England-wide basis?



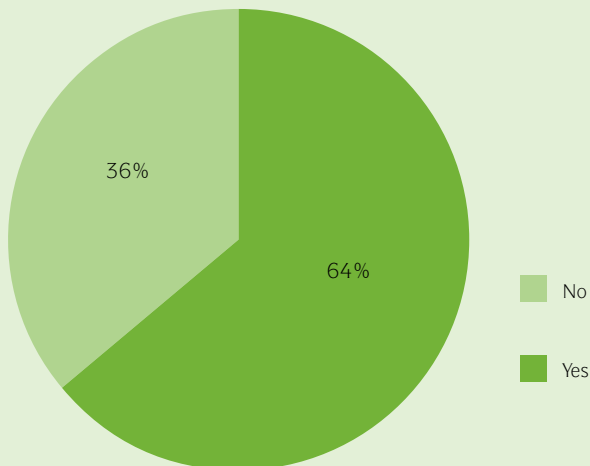
81.5% support the creation of a Local Authorities Mutual Fund in England.

**Figure 6** In principle, would you be minded to recommend your authority consider depositing a proportion of its reserves in a Local Authority Mutual Fund?



83.3% would deposit a proportion of their reserves in such a fund if it was created.

**Figure 7** Would your Authority be interested in borrowing capital from a Local Authority Mutual Fund at a competitive rate?



64% would consider borrowing from such a fund if it was offered at a competitive rate.

Figures 5-7 show a substantial level of support for the creation of a Local Authority Mutual Fund and indicate that it would be a competitive alternative to more traditional options for both investment and capital borrowing.

These figures should be treated with some caution as the form the Local Authority Mutual Fund would take was not specified in the survey and some authorities that support the idea in principle might find it unsuitable for their needs in practice.

However an 81.5% level of support is very encouraging, as is the fact that even authorities that do not necessarily support the idea in principle would be willing to deposit reserves once it had become established (83.3% are willing to deposit up from 81.5% supporting in principle).

The slightly lower level of interest in the fund as a source of capital for investment (64%) may indicate the differing attitudes towards lending criteria and conditionality, where some authorities may naturally choose differing strategies when borrowing as opposed to depositing. This result may also be a function of a proportion of respondents being relatively well endowed authorities who are interested in the fund primarily as an investment tool or a cautious attitude amongst Finance Directors who prefer to retain their current credit lines until an alternative has been clearly outlined.

In either case the survey still demonstrates a healthy and respectable level of interest amongst potential borrowers.

## 4 What form should it take?

The question of the form that the Local Authority Mutual Fund should take revolves around essentially three questions – firstly what type of financial instrument should it be, secondly how central to local authorities reserves will it be and thirdly what should its governance structure be.

To gain an idea of how local authorities envisage the Mutual Fund operating the survey asked which of a range of deposit options they would prefer, what they thought a reasonable percentage of reserves to dedicate to the Mutual Fund would be and their opinion on a range of governance options.

**Figure 8** Over which of the following periods of time should a Local Authority Mutual Fund offer competitive deposits for a typical local authority?

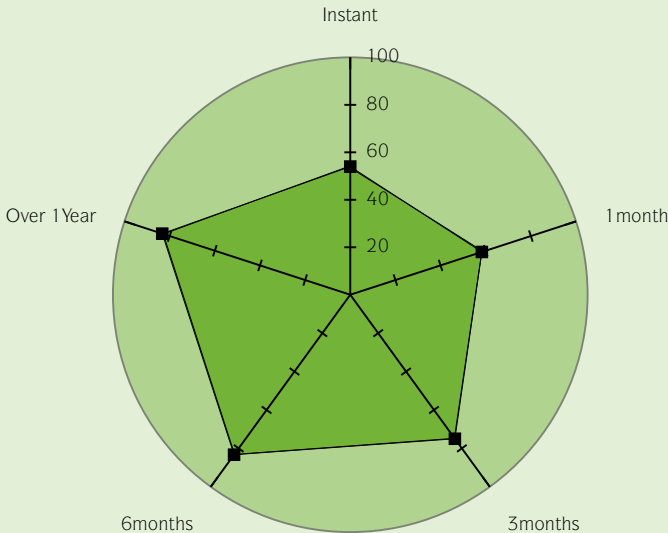


Figure 8 reveals an interesting picture of local authorities' preferences and the kind of Mutual Fund they envisage.

It is clear that Finance Directors are not interested in the fund solely as a specialist financial instrument but rather prefer a range of deposit periods

from “instantaneous” bank-account style withdrawal arrangements to long term investments of over a year in length.

Support is highest for the longer deposit options with both 6 month and over one year deposits having the support of 83.3%. However it should be noted that all deposit lengths have the support of over 54% of local authorities.

There is therefore potential for the Local Authority Mutual Fund to be a competitor to all current deposit options provided it can adopt a suitable balance of risk.

Longer term deposits offer the potential for more substantial lending to local authorities seeking capital for investment projects, a major purpose of the scheme, which generally have long timescales and delays before higher rates of return begin.

The overall level of support for deposits of over 6 months in length is therefore very encouraging as there would need to be a substantial number of local authorities committing reserves, either in the form of long term deposits or periodically in more short term instruments, to ensure this form of lending was viable.

**Figure 9** What proportion of a typical local authority's total reserves might be reasonable to consider on deposit at a Local Authority Mutual Fund?

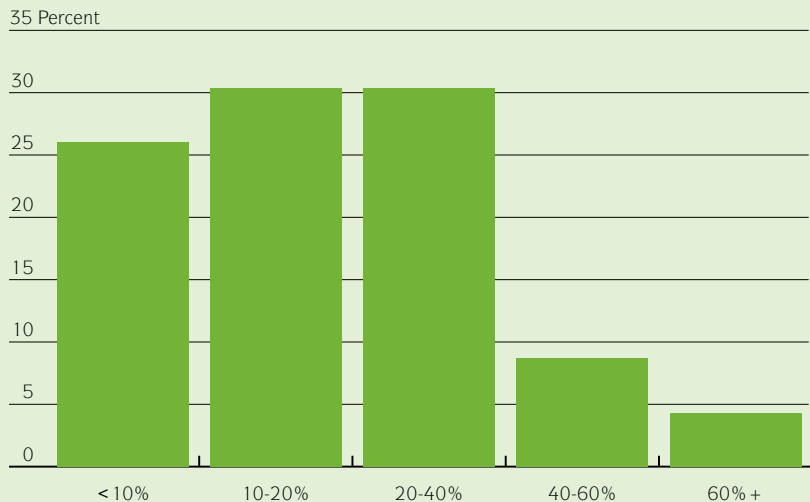


Figure 9 shows that the majority of Local Authorities would be willing to deposit between 10-40% of their reserves in a mutual fund.

The survey question did not specify whether the figures were as a percentage of total reserves or a proportion of unallocated reserves and so in itself it does not provide an accurate picture of the potential scale of the Mutual Fund.

However utilizing the data collected by the survey we can make an estimate of the potential size of the Fund.

We assume that the Mutual Fund will have an instant access resource, as preferred by the local authorities, and so will be likely to attract deposits from local authorities' earmarked reserves as well as unallocated reserves.

Using the stated levels of reserves and preferences for deposit levels we can estimate that local authorities would be willing on average to deposit between £1,167,613 and £8,409,090.

Assuming that this is a representative sample of local authorities in England and Wales approximately 334 local authorities of the 410 would sign up to the Mutual Fund creating a fund of between £389,982,742 and £2,808,636,060.

Even taking the most pessimistic of estimates the Mutual Fund would almost as large as all of Britain's current credit unions combined<sup>2</sup>.

The actual deposit levels are likely to be towards the higher end of the scale as the attractiveness of the Mutual Fund as a safe haven for local authority capital should not be underestimated, particularly in the light of the Icelandic banking crisis.

Overall this shows a great deal of potential for the Mutual Fund to act both as a major holder of local authority reserves and as an investment tool for local authorities, acting either as the primary source of funds or to augment other sources.

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<sup>2</sup> £400m in savings are held in Credit Unions in the UK. ABCUL Briefing December 2006

**Figure 10** What model of governance would you feel most appropriate for a Local Authority Mutual Fund?

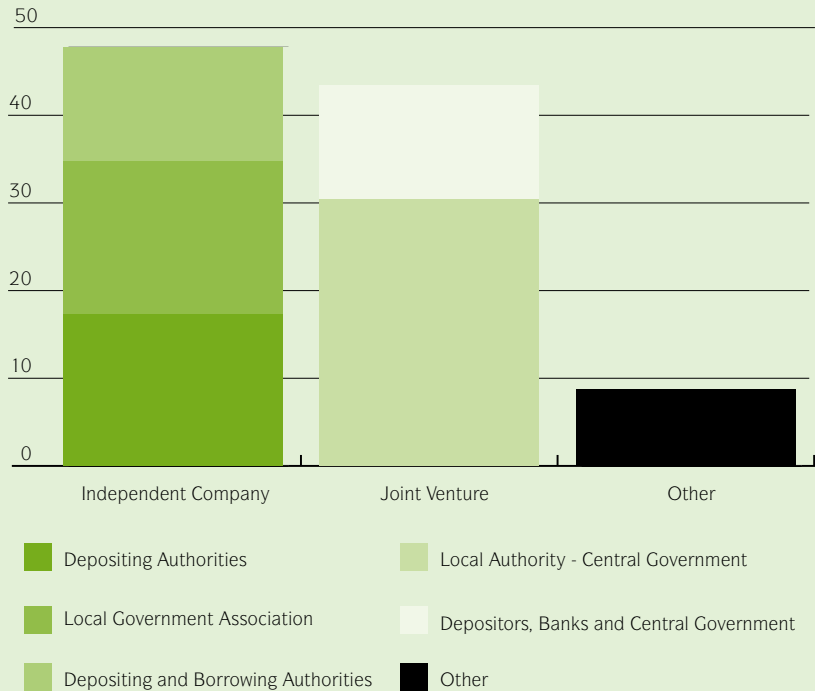


Figure 10 shows that the issue of governance of the Mutual Fund divides local authorities fairly evenly. The majority of local authorities (48%) support the founding of an independent company separate from both local government and central government structures. However the supporters of this form of governance are divided over the issue of which stake holders should be involved in the selection of the Board of Directors.

This group were evenly split between governance by a Board chosen by depositing Authorities and an LGA governed venture (17.4%), with support being lower for a Board chosen by both depositors and borrowers (13%).

The most supported solution was the idea of a Joint Venture between participating Local Authorities and Central Government (30.4%) but it should be noted that the Joint Venture option was less popular overall than the foundation of an Independent Company (43.4% in comparison with 48%).

It is perhaps understandable that Finance Directors, examining the idea of the Mutual Fund with little idea of the likely popularity of the scheme, might prefer a safer form of governance and so would opt for a Joint Venture model that limits the risk they would face.

It would not be unreasonable therefore to anticipate greater support for a more “self-governing” form of Local Authority Mutual Fund once the concept is developed in further detail and when the arrangements for the scheme and its potential scale are provided.

## 5 *Conclusion*

**This survey was conducted at the busiest time of year for council finance directors, at the height of their budget process and planning at the end of the calendar year. Despite this, we are grateful that twenty seven authorities took the time to provide a fresh insight into their current reserves policies and their attitudes towards any new mutual fund.**

Much work remains to be done to work through the consequences for both authorities and the wider market from any creation of a council mutual fund. Over the coming months the New Local Government Network will be working with partners and enthusiastic local authorities – Kent County Council having already gone on record in broad support of the proposal – to draw up an outline business case as the logical next step forward.

While the support and encouragement of Government would be desirable it is by no means essential. In an era where central-local relations are maturing and the local government sector ought to be maturing sufficiently to provide its own solutions to the challenges they face, we believe it would be preferable for the local government community to come together voluntarily with a scheme giving additional independence and concerted financial autonomy to the collected community of local councils. We take heart at the significant support for this proposition – over 80% in principle – and we will continue to pursue the concept vigorously throughout 2009.



**This paper describes the opportunity that exists to create an English Local Authority Mutual Fund whose purpose would be to provide a safe vehicle for reserve deposits which in turn might be lent in support of English local authority regeneration or infrastructure capital schemes.**

Our survey of a wide range of local authority directors of finance reveals significant support for the initiative – over 80% - and we estimate that if this level of support were repeated across the country a fund of between £389million and £2.8billion might be a viable proposition, larger than the combined assets of the UK's credit union holdings at present. On the basis of these results, the New Local Government Network – together with local councils eager to progress the concept and other specialist partners – intends to work up an outline business case for the creation of England's first council mutual bank.