UK Local Government Post Covid-19

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The Covid-19 crisis has increased costs for UK local authorities while revenue from property related taxes and from fees and charges is falling. This will put many UK local authorities under greater financial pressure with an increased risk that some may run out of money. The crisis has increased financial uncertainty for local authorities and highlighted some of the shortcomings of existing fiscal arrangements.

The UK government's decision in October 2019 to increase the lending margin that the Public Works Loan Board (PWLB) charges to UK local authorities has encouraged a growing number of commercial investors to lend directly to the sector as well as to invest in long lease assets with rents underpinned by local authority covenants.

Lending to local government is considered as low risk, however the credit profile of the sector is weakening and the risks between individual councils are widening. Investors may have to reassess their assumptions about sector risk, in particular the role of government support if the trend towards decentralisation and greater autonomy for local government is accelerated following the Covid-19 crisis.

Covid-19 Impact

In response to the crisis many local authorities are spending in excess of budgeted amounts in areas such as additional social care services, providing protective equipment for staff, and housing rough sleepers. Councils are at the same time losing revenue from business rates, council tax, and from fees and charges.

Many local authorities were already forecasting significant budget gaps before the Covid-19 crisis and these gaps have now widened. Local government has been at the forefront of austerity measures since the Global Financial Crisis and have implemented significant cuts, however the savings made by the sector over the past decade have been overshadowed by the massive amounts borrowed by central government in response to the Covid-19 crisis. While central government may have discarded economic orthodoxy at a national level, local authorities remain constrained by traditional financial disciplines.

The government is providing emergency grant funding to local authorities. This additional funding in response to Covid-19 is based on activities agreed by government, however there is some uncertainty as to whether the level of reimbursement will meet the full cost of the crisis. Government may provide further tranches of emergency funding, but it has not given an income guarantee to the sector.

A number of councils that have borrowed to invest in commercial property such as office and retail facilities have seen significant falls in revenue from these investments due to lockdown.

Emergency government funding is unlikely to be readily provided to cover the losses from speculative commercial investments by councils.

The difficulties in budgeting for cash flow uncertainties related to the crisis may mean that more councils will now face a greater risk that they cannot meet budgets and may be forced to declare insolvency.

Could a Local Authority Default?

A local authority can default on its financial obligations but there are a range of measures that reduce the risk of default. Ultimately central government has powers to intervene and prevent councils from defaulting, and to date no local authority has defaulted. In the event a local authority did default there are legal actions a creditor could pursue, including applying to the courts to appoint an administrator who could recover any debts owed from council fees and taxes.

The UK Government is unlikely to underwrite speculative commercial risks taken by local authorities

Local authorities cannot borrow to avoid operational shortfalls, however borrowing is allowed for investment purposes if it is considered to be affordable and not a risk to financially sustainability. The Prudential Code sets out a framework for self-regulated borrowing limits for each local authority. The vast majority of local authority borrowing is from the PWLB and levels of borrowing across the sector have increased significantly in recent years.

Local authorities are required by law to set a balanced budget and must meet their financial obligations when they become due. Councils that are not able to find sufficient savings or find additional income in response to funding gaps can over time become financially unsustainable and may have difficulties setting a balanced budget.

Local authorities that have concerns about their financial sustainability are typically those with responsibility for social care provision, which has particularly high spending pressures associated with it. Furthermore, as revenue becomes increasingly reliant on locally generated sources those councils with weak local economies and inappropriate strategies to improve local economic performance are also likely to be less financially resilient.

Councils have built up their own individual financial reserves that can be used to address short-term budgetary pressures. However, reserves should not be depleted year on year in order to set a balanced budget. The level of reserves can vary significantly between different local authorities and the relative size of reserves is a useful indicator of financial resilience.

In the event a council faces severe financial challenges which threatens its ability to deliver a balanced budget, then a Section 114 notice is issued which imposes emergency spending controls. Northamptonshire County Council issued a Section 114 notice in February 2018, the first such notice to be issued in over 20 years.

Over a number of years Northamptonshire Council had used its reserves to set a balanced budget. The reserves became severely depleted and the Council was in danger of not delivering a balanced budget. The Secretary of State appointed commissioners to step in and oversee key functions of the Council. Significant cost cutting measures were introduced and the Council was only allowed to spend on services that were considered to be a legal requirement.

Northamptonshire avoided default because of the step-in powers of central government. A number of other local authorities were already close to issuing Section 114 notices before the Covid-19 crisis hit. 2020/21 budgets across the sector as well as longer-term financial plans are under pressure from the response to the crisis and many councils are struggling to quantify cash flow shortfalls and to ensure that planned savings are delivered by year end.

Despite the financial pressures facing the sector, the systemic support provided by central government means that the credit ratings for UK local authorities have remained in the AA or A credit rating category. Local government ratings are considered to be closely linked to the sovereign rating. Declining sovereign credit quality as a result of central government's response to the Covid-19 crisis therefore should be expected to impact negatively on local authority ratings.

If the trend towards greater local autonomy and fiscal devolution is accelerated after Covid-19, then there is scope for a further weakening of links between central and local government. Risk analysis of local government after Covid-19 will need to give more weight to factors such as the strength of the local economy, strategic planning and capital investment decisions, management and governance, and the financial performance of the council.

Assessing Local Authority Lending Risk Post Covid-19

Local Authorities need greater financial autonomy in order to respond to the needs of their population

One consequence of the Covid-19 crisis has been a growing recognition of the role that local authorities have in protecting their communities. The failure of central government to mobilise local knowledge and local facilities for testing has been one of the major criticisms of the UK's response during the crisis. Recognition of the need to improve public health planning and management, along with the need for councils to take a more pro-active role in stimulating local economic growth, may lead to a new relationship between local and central government.

Under the current system, some local authorities that are under financial pressure are encouraged to borrow to invest in speculative commercial investments because this is one of the few ways additional revenues can be generated. The ease of getting low rate loans from the PWLB has contributed further to some councils taking on too much inappropriate risk.

Greater responsibility for key local decisions will need to be underpinned by financially sustainable arrangements. In the short term there may be some form of income guarantee from central government, but the direction of travel may be accelerated towards greater financial autonomy for the sector, including more flexibility to set local council tax and business rates. This is likely to encourage new forms of borrowing using locally generated sources of revenue to meet debt repayments.

The process of replacing government grant with retained business rates has already started to widen the differences in credit profiles between local authorities, and further decentralisation will continue the process of credit differentiation across the sector. An acceleration towards a more decentralised arrangement for local government would further weaken the systemic support factor that has helped keep local government ratings at very high levels.

It is unlikely any changes to the system of local government post Covid-19 would lead to UK local authority ratings falling into non-investment grade, but lower ratings across the sector and wider differentials between individual councils should be expected in the future. Lenders should recognise this increased risk and the need for more detailed and forward-looking analysis of individual local authority performance when developing frameworks for credit assessment.