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How early repayment of £800 million of LOBOs could be a game changer for councils

Capital and reputational reasons prompted RBS and other banks to offer generous refinancing terms to councils over the past year. Banks that held out against revaluation should now be compelled to follow suit.

An exclusive report by Nicholas Dunbar of Vedanta Hedging.

The last 12 months have been remarkable for a wave of restructurings of LOBO loans by UK councils. According to results of Freedom of Information requests conducted by us, among 55 of the largest LOBO borrowers surveyed, 21 of them reported refinancing some of their loan portfolio during this period.

Since we first highlighted the problem in a 2015 Channel 4 Dispatches documentary, LOBO loans have emerged as a major headache for austerity-strapped UK councils. The plunge in long-term borrowing rates after the Bank of England began quantitative easing in 2012 exposed the high costs of these loans, which had been heavily marketed by banks and brokers to local authorities before the financial crisis.

While many LOBOs were cheaper than Public Works Loan Board (PWLB) loans available pre-2008 – a result of the embedded options they contained – subsequent low gilt yields meant that the refinancing cost became prohibitive. Councils found themselves locked into LOBOs with a maturity of 50 years or more. Worse still, some of the structured variants such as inverse floater LOBOs exposed councils to rates of 7 per cent or higher.

Until recently, the only route available to councils was the uncertain path of litigation. Now, two banks – RBS and Germany's Commerzbank – have decisively changed the LOBO landscape by offering terms that allowed councils to repay £800 million of loans at a significant discount.

Although the councils have paid a total of £300 million in breakage costs in addition to the £800 million face value, the banks have written down £500 million in mark-to-market breakage costs to which they were contractually entitled. According to our analysis of FOI disclosures and mark-to-market valuations, RBS alone took a haircut of £430 million on the fair value of its LOBO portfolio.

Why would a bank voluntarily write off £430 million rather than stick with the full value of assets that aren't in default? Why would 20 councils voluntarily pay an extra £300 million now rather than letting the loans run for another 40-60 years?

To answer these questions, 1) we explore how councils go about refinancing LOBO debt from an accounting perspective, and 2) we look at how some individual councils did it. 3) We examine the motivations for banks to offer discounts. And finally 4) we explore the implications of the recent redemptions for the three big lenders that have resisted offering such discounts.

1) The council perspective

The idea of paying any break cost on LOBO loans may look unacceptable at first sight. To understand why a discounted cost might suddenly become compelling we must appreciate how councils see the instruments. One tool we already built to do this is our counterfactual: how much is the council gaining or losing by paying interest on the LOBO versus the cost of PWLB borrowing it could have entered into on the same date?

Aside from inverse or range LOBOs, which incurred dramatically high interest coupons after 2012, most LOBOs still look better than the counterfactual of a 20-year PWLB loan. That helps explain why most councils up to now have not sought to repay them.

We chose this counterfactual because it is the most common maturity across UK councils' borrowing from the government. But it is somewhat arbitrary because every council has a unique financing horizon. If we used a 10-year counterfactual, the picture changes as recent 2.5 per cent PWLB rates become available more quickly. Compared with that benchmark, all LOBOs are currently underwater.

For the 20-year counterfactual, that will happen in the next few years, while the LOBOs still have 30 or more years left to run. At this point, any council would seek to escape its LOBO burden if it could. But as we know, the break cost or repayment penalty holds them back.

Consider what happens when a LOBO gets repaid. The break cost does not have to be recorded as a one-off hit to a council's finances because of a clause in local government accounting rules. If the refinanced loan is being replaced with new debt from the PWLB, the break cost or premium can be amortised over the life of the new loans. In other words, it appears as an additional effective interest cost added to the coupons of the new debt.

For our database of 50 UK councils, we have prepared a tool that calculates this, called the 'break cost-implied refinancing rate'. It takes the full refinancing amount (break cost plus principal), the current PWLB rate of interest on this borrowing, adds the amortised premium and expresses the result as an effective coupon on the original principal.

For those councils that haven't refinanced LOBOs this year, that number is around 7.5 per cent. That's much higher than the actual interest cost of standard LOBOs (around 4-5 per cent). That explains why councils whose LOBOs are underwater compared with the counterfactual would stick with the loans, even when PWLB rates are below 2.5 per cent.

Here's the game changer: consider the break cost-implied refinancing rate for those councils that redeemed their loans in the last year. The discounts offered by the banks were enough to pull this rate close to, or below the counterfactual PWLB rate. This was enough to convince many councils to accept the banks' offer.

2) The councils that refinanced

We now look at the councils that did the £800 million of refinancings. In the database we started in 2015, there are 15 such councils, and the face value of loans paid back is shown in the chart below. Not shown here are three additional councils (Gateshead, Trafford and Lancashire) there were not present in this database.

Croydon did the biggest refinancing at £100 million of principal, but here we'll focus on the second biggest in the list: Cornwall county council, which in December refinanced £85 million of inverse LOBOs with RBS subsidiary NatWest Markets.

Being inversely linked to sterling swap rates, coupons on Cornwall's loans were above 7 per cent last year, and mark-to-market break costs were more than double the loan principal. The implied refinancing cost was more than 12 per cent: the council was trapped.

A 'LOBO Delegation Report' provided by the council to us tells what happened next. After what Cornwall described as two years of fruitless attempts by its adviser Link Asset Services to renegotiate the loans with RBS, the bank changed its tune in October. According to the report, RBS "made it clear that they want to divest themselves of these loans". It agreed to write off £100 million in market value, and ultimately accepted a redemption premium of just £47 million.

According to Cornwall's report, this discount was expressed as a spread of 190 basis points to the Gilt curve – treating Cornwall as equivalent to a BBB-rated corporate such as BT Group or Telefonica. The effective refinancing rate estimated by the council was between 4.2-4.9 per cent. That was lower than the counterfactual PWLB rate available to Cornwall at the start dates of the loans, and a lot lower than the actual rate the council was paying to RBS when they were refinanced.

The delegation report gives a good flavour of the council's experience as an inverse LOBO borrower. In the wake of the controversy sparked by Dispatches, it feared the loans would "continue to be the subject of criticism, challenge and Freedom of Information Requests (FOI's)". By refinancing, Cornwall concluded, "the continuing risk of challenges and criticism from various parties on the two inverse floating Lobo's is removed".

The prospect of spending years tied in knots by debt activists and 'citizen auditors' may have spurred other inverse LOBO councils such as Sheffield, Lancashire and Newcastle to reach similar deals with RBS.

Although it accounts for the lion's share, RBS is not the only bank appearing in the FOI disclosures. Redcar & Cleveland council repaid £31.6 million of LOBOs last year: firstly with Commerzbank in July and then with Austrian bank KA Finanz in October. Because these were standard (less risky) LOBOs, the discounts were smaller: expressed as spreads to Gilts, they were the equivalent of AA-rated Nestle or A-rated BMW. In terms of the effective refinancing rate, Redcar achieved a positive result, paying less than the counterfactual PWLB rate on some of the loans.

3) The bank viewpoint

The banks don't offer such discounts to be nice. As we have written before, under pre-2008 regulations, LOBOs were highly profitable for lenders. But the world has changed.

To understand how, we need to look at the capital rules that now govern banks. For the likes of RBS and Commerzbank, this is expressed in the common equity tier 1 (CET1) ratio. The denominator of the ratio is the CET1 capital of the bank. If it writes down an asset on its balance sheet by agreeing a discounted redemption, this loss gets deducted from its CET1 capital.

Now consider the denominator, or risk-weighted assets of the bank, which measures its required regulatory capital as calculated under Basel rules. LOBO loans incur different types of capital requirement, and if a loan is repaid, the RWAs are immediately reduced as a result.

Since the financial crisis, banks have been under remorseless pressure from regulators and shareholders to improve their CET1 ratios. Since no shareholder-owned bank would ever give something away, we can assume that any acceptable LOBO redemption offer would have to increase this ratio.

Armed with this knowledge we can devise LOBO redemption rules for particular banks. Take RBS, whose CET1 ratio is currently 16.2 per cent. The loss of £100 million on the Cornwall redemption for example would have to be offset by an RWA reduction of at least six times this amount, or £600 million.

Or consider Commerzbank, with a CET1 ratio of 12.8 per cent. The £9 million written down on the Redcar & Cleveland LOBOs would require a £70 million reduction in RWAs to be justified from a capital perspective.

How might a bank achieve this reduction? There are three parts of a LOBO capital requirement – credit risk, market risk and operational risk. The credit risk part comes from the possibility that a council could default on the loan, and the UK government wouldn't bail it out. Then there is counterparty risk from the derivatives used to hedge the LOBO.

Market risk comes about from the potential for extreme moves in interest rates or volatility not covered by the hedges the banks have in place. For inverse LOBOs, which are leveraged derivatives products, this risk is significant. According to RBS, there is some evidence that this has been a problem in recent years at NatWest Markets, the non ring-fenced subsidiary that runs the LOBO book.

"In NWM, the back-testing exceptions in May and December 2018 were mainly driven by losses in the Rates portfolio", RBS said in its Pillar 3 Report for 2018.
A bank with too many VaR exceptions is required to hold additional market risk capital, which adds pressure on the bank to redeem legacy LOBO positions.

Next comes operational risk, which amounts to the possibility of a legal provision or settlement with a council, and the possibility that a claim would result in regulatory misconduct findings and fines against the bank. Taking all these together, the impact on RWAs makes LOBO redemption discounts an act of self interest by the banks. On top of that are a slew of other things such as leverage ratios, stress tests and prudential valuation adjustments, which make long-dated, hard-to-value derivative products a headache for banks, which further support the case for discounts.

And for RBS there is an additional reputational issue – as a mainstream UK high street bank, the scandal of inverse LOBOs simply became too toxic for a taxpayer-owned institution, with councillors heckling the bank's senior management at its annual general meeting. With legacy baggage out of the way, RBS can start afresh on its UK public sector relationships.

4) Exposing the holdouts

A further game-changing aspect of last year's LOBO redemptions comes from the way it exposes the stale valuations of the big lenders that haven't joined the repayment bandwagon. Extrapolating from our data, these lenders account for 80-90 per cent of the market. Here we'll focus on the three biggest holdouts: Barclays (with £2.3 billion loans in our database), Dexia Credit Local (£1.8 billion) and FMS Wertmanagement (£1.3 billion).

All three banks are keeping councils trapped in their loans with high break costs. Remember the break cost-implied refinancing rate? For these three banks this averages just below 8 per cent – in other words, that is the rate councils would end up paying for the next 40-50 years if they refinanced those loans into PWLB debt today. That can't be justified economically.

Such a high refinancing cost is a consequence of the market-based valuation that the three banks use to compute break cost. This is the price that councils would have to pay to buy back the embedded derivatives in their LOBOs using the risk-free or Libor-based pricing which was a hallmark of the pre-crisis over-the-counter derivatives market.

Of course, no dealer trades derivatives like that today. These days, derivatives are funnelled through something called XVA, which adjusts pricing to factor in counterparty credit spreads among other things. For very long-dated contracts like LOBOs, the credit valuation adjustments can be large. If Barclays, FMS and Dexia priced their LOBO books properly, they would incorporate this, and write down the market valuations accordingly. They would include this pricing in their redemption terms as well.

The reason they don't do this is because they don't want to recognise these losses, and they don't have to in the case of FMS and Dexia, because both are zombie banks that collapsed and were bailed-out. Their German and Belgian government owners are trying to unwind their assets without losing taxpayers' money.

Witness this passage from the 2017 annual report of FMS which refers to the public sector portfolio including LOBOs:

“The options for speeding up the unwinding of segment exposures are limited. The loans and securities were all extended or issued before the financial crisis broke out, at a time when the market accepted much lower margins. Therefore, in the current market environment, with potential buyers expecting higher returns, they could only be sold at a heavy loss. In addition, many of the exposures held are very illiquid, which would lead to further price discounts were they to be sold early”.

But given the discounted redemption evidence compiled by us, this argument is flimsy. It could be argued that the recent discounts are pricing points that need to be included in loan valuations. Doing otherwise would be dishonest accounting. If councils made FMS and DCL aware of this, they might be compelled to start offering discounted redemptions.

We put this argument to FMS and a spokesman responded: “As a German government agency, we are in a way comparable to UK Local Authorities as our implicit stake holder is the tax payer”. He added that pricing points which a fair value framework would have to incorporate could be ignored by FMS because it used book value accounting: “FMS-WM has German GAAP accounting in place where a mark-to-market approach isn’t applicable”.

Barclays is different. As a shareholder-owned bank subject to similar capital rules as RBS, Barclays has sought to neutralise the risks of its LOBO portfolio while keeping councils on its books as long-term borrowers.

We wrote about this a couple of years ago, describing how in 2016 the bank unilaterally waived the option characteristics of its LOBOs. Turning the loans into straightforward fixed-rate debt would have significantly reduced the RWAs for the portfolio.

Painted as a giveaway by the bank, the waiver was really an act of self-interest that conceded very little to councils. After doing that, Barclays then moved its LOBO book from fair value accounting to amortised cost, which has the effect suppressing any evidence that the loans have changed value, unless they become impaired.

But Barclays has a couple of weak spots on the LOBO front. First of all, in 2015 the bank wrote down the fair value of its LOBOs by £900 million before its move to accrual accounting – but this was never passed on to borrowers in the form of redemption offers. Secondly because of the interest rate derivative embedded in the contract, the redemption pricing uses sterling Libor as an input. But Barclays has already been fined for rigging sterling Libor and can be targeted under a fraudulent misrepresentation claim.

Dozens of councils filed such a claim last year, which if successful could see the original contracts being ruled invalid by court order, irrespective of the subsequent waiver. Fear of this outcome gives Barclays every incentive to sit down and negotiate a discounted redemption with these councils. (As a baseline for discussions, the councils could even start by using the RBS and Commerzbank discounted redemption data compiled by us.)

None of this will be easy – it needs strategic thinking by local authorities and good external advice. Given that councils across the UK have about £14 billion of LOBOs left outstanding, last year's redemption wave could yet turn into a tsunami.

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