Leicestershire County Council

CORPORATE GOVERNANCE COMMITTEE – 13 MAY 2022

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED CHANGE TO THE ANNUAL INVESTMENT STRATEGY TO ADD TO THE LIST OF ACCEPTABLE INVESTMENTS

Purpose of the Report

1. The purpose of this report is to seek the views of the Corporate Governance Committee about a recommended change to add Bank Risk Sharing Funds to the list of acceptable investments within the Annual Investment Strategy. This will enable an investment of £10m to be made as part of the Corporate Asset Investment Fund into Christofferson Robb and Company's (CRC) Capital Relief Fund 5 (CRF5). The Committee's views will be included in a report to the Cabinet on 24 June 2022, with a view to making the commitment to invest in CRF5 in the following weeks.

Policy Framework and Previous Decisions

2. Treasury management is an integral part of the County Council's finances. The Treasury Management Statement and Annual Investment Strategy, and the Corporate Asset Investment Fund for 2022-26 were agreed by the Full Council in February 2022 as part of the Council's Medium Term Financial Strategy (MTFS) 2022/23 – 2025/26. The Committee reviewed and commented on the Treasury Management Strategy Statement and Annual Investment Strategy 2022/23 at its meeting in January 2022 prior to this being considered by the Cabinet.

3. The approved MTFS 2022-26 sets out the need for savings of £100m to be made by the Council by 2025/26, of which £46m is as yet unidentified.

Background

4. The Corporate Asset Investment Fund (CAIF) Strategy 2022-26 allows up to £260m to be invested into the CAIF. The latest investment plans for the CAIF show that there is headroom of £48m available for new CAIF schemes. This includes investments to date and planned investments in the draft 2022-26 MTFS.

5. There is an opportunity for an investment of £10m to be made as part of the CAIF into Christofferson Robb and Company's (CRC) Capital Relief Fund 5 (CRF5). Direct CAIF property investments have been delayed due to a

number of factors including the Covid-19 pandemic and as such an investment into a fixed term investment such as the one proposed allows the CAIF to earn a return whilst waiting for when the money can be deployed in line with long term ambitions.

6. To enable such an investment to be made, a change is required to the Annual Investment Strategy 2022/23 to add Bank Risk Sharing Funds to the list of acceptable investments. The Bank Risk Sharing Funds being considered have an investment life of approximately six years. The investment period is scheduled to end in December 2022, this would imply money would be fully returned to the CAIF in the year 2028 and be available for other CAIF investments including investment into direct property at that time.

Proposed Amendment to the Annual Investment Strategy

7. The Annual Investment Strategy (AIS) (as contained within the Treasury Management Strategy and Annual Investment Strategy) includes details of the investment instruments that may be used in the financial year. For 2022/23, this was approved by the Council at its meeting in February 2022 as part of the 2022-26 MTFS.

8. The proposed investment with CRC detailed within this report will require an amendment to the AIS, and the list of acceptable investments. The proposed amendment to the table is shown below. The full table can be found as part of the February MTFS report, Appendix N. https://politics.leics.gov.uk/documents/s166691/Appendix%20N%20-%20TMS%202022-26%20CGC%20version.pdf

9. The maximum amount proposed is £15m. This is higher than the £10m proposed investment into the CRC CRF5 investment. This increase allows the CAIF to make a follow on investment into this investment class when the existing investment is returning capital to the CAIF should that be considered appropriate at that time.

Investment	Repayment within 12 months	Level of Security	Maximum Period	Maximum % of Portfolio or cash sum[1]
Bank risk sharing funds	No	Diversification within pooled fund, resilience of SME loans to default and historic loss rate suggests good security	Varies across funds – likely to be at least an 18 month investment period, followed by a further 5 years to full redemption	£15m

10. The investment will be accounted for as a treasury management investment, in the same way as existing Private Debt investments. This will be confirmed with the Council's treasury management advisors and external auditors prior to any such investments being made. It is expected to be treated as treasury management but if this not the case and income needs to be treated as a capital receipt then returning capital can be treated in a similar way to the CAIF's pooled property investment, this will be manageable as part of the Council's capital funding programme.

What are Bank Risk Capital Release Funds?

11. Within the banking regulatory environment, capital has to be held as backing for loans that have been made. This is to ensure that the bank has adequate 'buffers' against losses under a range of scenarios. Hence, if a bank wishes to increase its lending activity it has to hold more regulatory capital and this capital can be expensive. For example, raising equity can be difficult if the amount to be raised is a large portion of the existing equity value. The riskier a loan the more a bank needs to hold in reserve as backing.

12. By arranging a mechanism for transferring the risk of loans made, banks can receive approval from the regulators to hold less regulatory capital against existing loans. This releases capital to support other activities. As capital is expensive for banks, they can afford to pay a healthy premium to the counterparty that the risk is being transferred to. The risk transfer and the approval by regulators make bank capital release attractive to both the bank and the investor. The banks end up with lower risk weighted assets (loans weighted on the level of risk they present to the bank) and better capital ratios.

13. Risk Sharing Transactions (RSTs) are typically structured by creating a special purpose vehicle (SPV) which insures the first (or second) tranche of losses on the bank's underlying loan portfolio for a specified period.

14. The SPV reimburses the bank if relevant losses are sustained and receives a quarterly premium from the bank for doing so. The SPV is financed by issuing a note with a coupon that matches the insurance premium and a maturity which matches the term of the insurance (which is typically 3-5 years). The bank retains responsibility for loan servicing.

15. Returns to investors in the fund come from the insurance premium paid by the bank which will be distributed quarterly to investors, less management fees. The invested capital will be returned at the end of the term less any losses reimbursed.

16. RST managers may also engage in the outright purchase of non-performing loan ("NPL") portfolios, but these usually represent only a small proportion (up to 20%) of the overall portfolio.

17. In such transactions, the RST manager is exposed to all credit losses and takes responsibility for loan servicing.

18. The overall risk is higher than the Council's usual treasury management investments but represents good return for the risk taken given the main portion of the fund invests in performing loans which become less risky over time as loans are repaid.

Who is Christofferson Robb and Company (CRC)?

19. The proposed policy change will allow different managers. However, the focus on the next two sections is CRC as they are likely to be the only manager employed this year.

20. Christofferson Robb and Company (CRC) is a private credit manager who specialise in European bank capital release. The firm was founded in 2002 by Richard Robb CEO and Johan Christofferson the Managing Partner. The firm manages c$5bn in assets of which bank capital release transactions account for the vast majority of assets.

21. CRC, is highly specialised in this area and has been carrying out bank risk transfer transactions since 2002 and has been able to produce consistently good returns for investors.

22. Pension schemes comprise 65% of the firm's assets under management and includes UK pension funds, with most investors domiciled in North America. They employ 57 staff split mainly across London and New York.

23. Since 2004 they have focused on capital release transactions for European banks' loans to consumer and small medium enterprises (SMEs).

24. They have a long track record in this area with their first risk sharing transaction commencing in 2002. It is estimated that over the last seven years CRC's market share in this area has been 36%.

25. The Leicestershire County Council Pension Fund has invested with CRC since 2017 when a £40m commitment was made. In 2021 a further commitment of £52m was approved by the Pension Committee.

26. To date the CRC team has shown a strong track record in minimising capital losses, with less than 0.1% of invested capital lost.

What is Capital Relief Fund 5 (CRF5)?

27. This is the latest fund from CRC and is expected to open until December 2022. The Fund targets to raise at least €500m for these risk transfer transactions mainly with European banks in Italy, Germany, Portugal, France, Spain, and Greece. Each investment CRC will make will be linked to 500-30,000 SME loans.

28. CRC has a competitive advantage through the development of strong bank relationships in Europe and repeat transactions. CRC has extensive expertise in structuring Risk Sharing Transactions and the strategy is core to the manager's business. They have built the required infrastructure to manage this strategy, including the development of the proprietary investment system "Casa", built to model and manage bank balance sheet securitisations.

29. CRC focuses on SME loans which are shown to have less variable default levels than larger-cap corporates. Even following the Global Financial Crisis in 2008 the losses on SME loan portfolios peaked at 0.8% versus the losses on all rated corporate credit instruments of 3.6%. (Moody’s Annual default study: Corporate Default and Recovery Rates, 1920-2014)

30. Due diligence was conducted by Hymans Robertson on CRF5 on behalf of the Pension Fund investment in 2021 and outlined a number of conditions that are present before CRC will enter into a capital release transaction with a bank with some of the most notable being:

- The bank should be motivated to improve its capital ratios.
- Pools of loans should primarily be loans to SMEs, as default rates show a muted response to the business cycle relative to public rated corporate loans.
- Pools of loans should be highly diversified, i.e. containing 500 – 30,000 loans to SMEs, to insulate CRC from idiosyncratic risks.
- Pools of loans should be selected using mechanical rules that CRC has a hand in establishing.
- Regulators must approve all transactions, either individually or as part of a programme.
- CRC prefers deals that are non-replenishing and amortise over time, through underlying loans being repaid. i.e. as time passes the level of risk to the CRC investor reduces.

<u>Resource Implications</u>

31. The overall investment in the CAIF portfolio as at 31st March 2022 is £188m. The proposed investment of £10m into CRF 5 represents c5% of the overall amount invested as at the year end. The investment will be made using existing CAIF cash resources.

32. The expected return from the Bank Risk Sharing Funds is higher than the return from standard treasury management where cash is left on deposit and as a result carries a higher risk of capital loss. Capital preservation is a key objective of Treasury Management and as a result the amounts being proposed for bank risk sharing funds are a small proportion of the overall CAIF. Complementing the standard treasury management investments will also provide some protection against erosion from rising inflation.

33. By investing £10m in the proposed investment, the Council would forego bank interest estimated at £150k per annum based on the prevailing rate (April 20th 2022) of 150 basis points for a 12 month fixed term deposit. Bank rates are floating and as such have started to move higher over 2022 as UK interest rates have risen. This increase in interest forgone is mitigated, as the investment in CRF5 is also based on floating interest rates.

    Management and monitoring of the proposed investment will be via existing resources and through the existing CAIF and treasury management governance structures as detailed below.

34. The new CIPFA code of practice (2021 edition) allows the Council to continue to invest in long term investment products. This investment can be defined as a treasury management investment whilst there is a link to cash flow management or treasury risk management.

35. The Director of Law and Governance has been consulted on the proposals

Risk Assessment

36. The key risks and mitigations associated with Bank Risk Sharing Funds are set out below.

37. Increase in loan defaults
    a. The portfolio has built significant buffers to ensure that positive returns are generated even if loan losses significantly exceed the peak of the global financial crisis.
    b. Loans are selected using mechanical rules and random selection. Loans on a bank's watch list are excluded from the portfolio, which should bias portfolio loan quality upwards.
    c. Diversification to spread the risk by sourcing loans from multiple banks from multiple countries.
    d. Exposure declines over the life of the investment, but premiums received are maintained.

38. Bank default
    a. Insurance arrangement ends – loss of interest payments.
    b. Any deposits made with the with bank are exposed, but no more so than loan protection offered.

39. Liquidity
    a. The investment would be expected to be held to maturity.

40. Regulatory changes
    a. Transactions receive regulatory approval
    b. If further transactions are not possible outstanding invested capital would be returned to investors.

41. Investment manager insolvent
    a. The regulator requires a replacement manager and an independent custodian to be put in place.

42. The rationale to invest in this asset class balances the overall risk to the CAIF by diversifying away from UK property, indirectly owned property via pooled investment funds and pooled infrastructure.

43. In common with many financial investments there are a range of financial risks which include, foreign exchange risk, market competition, underlying companies or sectors suffering from regulatory, tax, political and climate change to name a few. The proposal to invest is considered acceptable for the level of expected return. The proposal forms part of a diversified portfolio and any underperformance would not be overly detrimental to the CAIF as a whole. The proposal is of moderate risk which decreases as time passes towards the target life of the investment.

44. The CAIF investment will be monitored on a quarterly basis and reported to the Corporate Governance Committee, as part of the standard treasury management reporting. It will also be subject to an annual report to the Scrutiny Commission and the Cabinet.

Timetable for Decisions

45. Subject to any comments made by this Committee, it is intended that a report will be presented to the Cabinet at its meeting on 24 June 2022 that will seek its agreement to :

    (i) 'Bank Risk Sharing Funds being added to the list of acceptable investments included within the Annual Investment Strategy.
    (ii) an investment of £10m from the Corporate Asset Investment Fund into Christofferson Robb and Company's (CRC) Capital Relief Fund 5 (CRF5).

The proposals will first be presented to the Scrutiny Commission for consideration at its meeting on 8th June 2022 prior to the Cabinet's approval being sought.

Equality and Human Rights Implications

46. There are no equality or human rights implications arising from this report.

Recommendations

47. The Committee is asked to consider this report and to provide any comments that it would like the Cabinet to consider.

Background Papers

48. Report to the Cabinet on 5 February 2021 “Revised Corporate Asset Investment Fund Strategy 2021 to 2025”: - http://politics.leics.gov.uk/ieListDocuments.aspx?CId=135&MID=6440#AI66682

49. Report to the County Council on Medium Term Financial Strategy 2022/23 – 2025/26: https://politics.leics.gov.uk/ieListDocuments.aspx?CId=134&MId=6481&Ver=4

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50. None.

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