Leicestershire County Council

SCRUTINY COMMISSION - 8th JUNE 2022

RECOMMENDED CHANGE TO THE ANNUAL INVESTMENT STRATEGY AND INVESTMENT IN CHRISTOFFERSON ROBB AND COMPANY'S CAPITAL RELIEF FUND 5

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

Purpose of report

1. The purpose of this report is to advise the Scrutiny Commission of a proposed change to add Bank Risk Sharing Funds to the list of acceptable investments within the Annual Investment Strategy. This is to enable a proposed investment of £10m to be made as part of the Corporate Asset Investment Fund (CAIF) into Christofferson Robb and Company's (CRC) Capital Relief Fund 5 (CRF5), details of which are set out below. The Scrutiny Commission's views on the proposed investment are sought. These will be included in a report to the Cabinet on 24 June 2022 in which approval of both matters will be sought.

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 Strategy 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.

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.

4. The recommended addition of Bank Risk Sharing funds as an acceptable investment within the Annual Investment Strategy is an in-year change that requires the approval of the Cabinet. This will be reflected in the revised Treasury Management Strategy when the MTFS is updated for 2023/24 – 26/27

5. The Corporate Governance Committee considered a report on 13th May 2022 regarding the proposed change to the Annual Investment Strategy. It supported the proposal.

Background

6. There is an ambition to build the value of the portfolio up to £260m so that this can generate a meaningful income for the Council and support Council services. The proposed spend of £10m into CRF 5 represents c5% of the last year end CAIF

valuation and allows the CAIF to deploy capital and receive income whilst new direct property investments are being planned.

7. The proposal to invest £10m into a Bank Risk Sharing funds (CRF5) is in line with the CAIF Strategy which supports investing in non property asset classes to improve the Fund’s diversification and secure greater income generation whilst capital is not required for direct property investments.

What is Bank Risk Sharing?

8. Within the banking regulatory environment, capital has to be held as backing for loans. This is to ensure that the bank has adequate ‘buffers’ against losses under a range of scenarios.

9. 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.

10. 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.

11. The risk transfer and the approval by regulators makes bank capital release attractive to both the bank and the investor. As capital is expensive for banks, they can afford to pay a healthy premium to the counterparty that the risk is being transferred to. In return, 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.

12. 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.

Who is the proposed investment manager – Christofferson, Robb & Company?

13. Christofferson, Robb & Company (CRC) is a private credit management firm that was founded in 2022 and which specialises in European bank capital release i.e. investing primarily in transactions that transfer the credit risk of banks’ to funds it manages, as explained above.

14. CRC manage c$6bn in assets of which bank capital release transactions account for over 90% of the assets. The firm is based in London, has approximately 60 staff and is still managed by the founders of the firm, Johan Christofferson and Richard Robb.

15. Since 2004 CRC has focused on capital release transactions for European banks’ loans to individuals and small and medium sized enterprises (SMEs). It has a long track record in this area and has been able to produce consistently good returns for investors. It is estimated that over the last seven years CRC’s market share in this area has been 36%. To date the CRC team has also shown a strong track record in minimising capital losses, with less than 0.1% of invested capital lost.

16. It is worth noting that 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 into the current product CRF5.

What is Capital Relief Fund 5 (CRF5)?

17. CRC5 is the latest investment fund from CRC and is expected to be open for commitments until December 2022. The Fund is targeted to raise at least €500m for Bank 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.

18. The product is expected to have a life of 6 years, by which time all capital is scheduled to have been returned. The capital can be redeployed into CAIF investments that meet the needs of the Fund. The management and performance fee payable to CRC is in line with that being paid by the Leicestershire Local Government Pension Scheme.

19. CRC focuses on SME loans which are shown to have less variable default levels than larger companies. 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%. (Numbers taken from a Moody’s Annual default study: Corporate Default and Recovery Rates, 1920-2014.)

20. Responsible investment is a key part of CRC’s investment process as using ESG (environmental, social and governance) screens can reduce risk. Each bank’s ESG policy is assessed to ensure it conforms at a minimum to CRC’s ethical criteria. The ethical criteria are drawn from the UN Global Compact and sets out the type of companies that CRC avoids along the following considerations: human rights, employment, environment, bribery and corruption and weapons.

21. Due diligence was conducted by Hymans Robertson on CRF5 on behalf of the Leicestershire Local Government Pension Scheme (LGPS) Fund investment in 2021. This 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 are preferred to 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.

22. Officers have monitored the progress of CRF5 since the Leicestershire LGPS investment, noting that investment into Bank Risk Sharing transactions is being completed as expected with no change to the investment strategy employed by CRC. CRC have informed officers that they are still on track to end the investment period at the end of 2022 as originally intended.

23. The investment of £10m represents c5% of the value of the CAIF as at 31st March 2021. The investment will become a smaller part of the CAIF as more investments are added to the CAIF. The addition of this investment will further diversify the returns from the CAIF which are predominantly derived from directly owned and managed property.

Risk Assessment

24. The key risks associated with Bank Risk Sharing Funds and the mitigations put in place by CRC to address these, are set out below.

(a) Risk – Number of loans not repaid by the individuals or SMEs higher than expected.

Mitigations include:

- The terms agreed when CRF5 purchases a portfolio of loans has built significant buffers to ensure that positive returns are generated even if loan losses significantly exceed the peak of the global financial crisis.
- The loans that are selected within each Bank Risk Sharing transaction use mechanical rules and random selection. Loans on a bank's watch list are excluded from the portfolio, which should bias portfolio loan quality upwards.
- Loan officers at branch level banks are unaware of which loans are part of a Risk Sharing Transaction. All loans are managed by branch loan officers in the same manner.
- Diversification to spread the risk by sourcing loans from multiple banks from multiple countries.
- Financial exposure declines over the life of the investment as loans are repaid by borrowers. This reduces the amount owed overall by the borrowers however, the premiums received by CRC and are maintained.

(b) Risk – Lending Bank becomes insolvent and is unable to continue operations

Mitigations -

- CRC structure transactions so as to be remote from counterparty exposure i.e. if bank defaulting, investment can't be used to bail in the bank, investment is ring fenced.

- Insurance arrangement ends – loss of interest payments, principal investment repaid.

(c) Risk – Liquidity – this is the ability to realise any investment made into CRF5 before its natural end. There is a limited secondary market for these types of investment and as such liquidity is low.

Mitigations -

- There is little liquidity to realise the investment earlier than the scheduled return of capital which is expected to be six years. The investment would be expected to be held to maturity. One of the reasons returns are higher in certain investments is due to the illiquidity premium, this being the additional return that is required in return for not having ready access to the capital.

(d) Risk - Regulatory changes – there could be changes to way European banks are regulated. The Bank Risk Sharing transactions could become more or less favourable method of managing the capital requirements for a bank, but the trend in recent years has been consistently in favour of Bank Risk Sharing transactions and as such the supply of transactions has increased.

Mitigations -

- Transactions receive regulatory approval before being completed and included within the portfolio of investments.
- If further transactions are not possible outstanding committed capital would be returned to investors.

(e) Risk - Investment manager insolvent – this refers to CRC who are the investment manager becoming insolvent and unable to continue management of CRF5.

Mitigations -

- The regulator requires a replacement manager and an independent custodian to be put in place. These provisions are included within the contract to make an investment into CRF5.

26. 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. This is in line with a review of CAIF completed by Hymans in 2020 where they advised the CAIF to, “consider additional allocations, either to private debt funds or other income-focused asset classes”. The CAIF has since had an approval to invest £7.5m into an infrastructure fund and £20m to a private debt fund.

27. 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 risk of the proposed investment 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 six years for the investment.

28. 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.

Resource Implications

29. The total value of the CAIF portfolio as at 31st March 2021 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.

30. By investing £10m in the proposed investment, the Council would forego bank interest estimated at £150,000 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.

31. The returns from the investment are not guaranteed and will be influenced by a range of factors, not all of which are in the fund managers control. The returns are expected to be 8% to 9% per annum and are linked to interest rates.

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

33. The Director of Law and Governance and the Director of Corporate Resources have been consulted on the content of this report.

Timetable for Decisions

34. The comments made by the Scrutiny Commission will be included in the report to the Cabinet at its meeting on 24th June 2022. If the variation of the Annual Investment Strategy and the proposed investment of £10m in CRF5 is approved by the Cabinet, the amended Strategy will come into effect immediately and the planned investment will be made as soon as is reasonably practicable.

Equality and Human Rights Implications

35. There are no equality or human rights implications arising from the recommendations in this report.

Recommendation

36. The Scrutiny Commission is asked to comment on the proposal to

invest £10m into a Bank Risk Sharing fund, CRF5, with Christofferson, Robb & Company.

Background papers

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

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

Report to the Corporate Governance Committee, “Recommended Change to the Annual Investment Strategy to add to the List of Acceptable Investments.”
https://politics.leics.gov.uk/documents/s168985/Recommended%20Change%20to%20the%20Annual%20Investment%20Strategy_Final.pdf

Circulation under the Local Issues Alert Procedure

37. None

Officers to Contact

Mr C Tambini, Director of Corporate Resources
Tel: 0116 305 6199
Email: Chris.Tambini@leics.gov.uk

Mr D Keegan, Assistant Director Strategic Finance and Property
Tel: 0116 305 7668
Email: Declan.Keegan@leics.gov.uk

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