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SCRUTINY COMMISSION – 28TH JANUARY 2009

TREASURY MANAGEMENT
REVIEW OF COUNTERPARTY LIST

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

Purpose of Report

1. To report on the outcome of a fundamental review of the list of counterparties to whom the Council can lend money as part of its Treasury Management activities.

Background

2. The term treasury management is defined as:-

   "The management of the local authority's cash flows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks".

3. The Director of Corporate Resources is responsible for carrying out treasury management on behalf of the County Council, under guidelines agreed annually and contained within the Treasury Management Policy. Under the CIPFA Code of Practice it is necessary for treasury management policies and actions to be reported to members, and this review is sufficiently fundamental to seek approval of the recommended changes.

What caused the current crisis?

4. The current economic conditions, and in particular the state of financial markets, have placed severe strains onto the World's banking system. The reasons for the current situation are complex but mainly relate to an over-extension of credit to individuals and businesses who, unless the extremely benign economic conditions had continued indefinitely, would have found it very difficult to repay their debts. The severe downturn in the US housing market effectively set off a chain of events that showed quite how far this 'toxic debt' had spread, and how exposed the banking system was to the reduction in loan quality.

5. The massive write-down in the value of banks' loan portfolios caused by the worsening economic situation meant that banks needed to hold onto as much of their own capital as they could, in order that they could maintain capital ratios that were acceptable to central banks. This meant that they had little-or-no excess cash to lend, but they were also unwilling to lend this to other banks as they had no idea of the actual state of the financial position of the prospective counterparty. This effectively led to the inter-bank lending market seizing up, and the law of demand-and-supply meant that banks had to pay much more than they would have expected to in order to finance their cash requirements.

6. As banks found it increasingly expensive (and sometimes impossible) to borrow cash within the market, Governments were faced with the option of either allowing some of them to fail or offering support. The knock-on impact of a significant failure onto the rest of the banking system, onto public confidence and onto the real economy was such that this was not an acceptable option – the queues outside Northern Rock and the necessity for the UK Government to step in gave a clear warning of the risks involved.

7. The nationalisation of Northern Rock was an extreme example of Government intervention, but throughout the World it became necessary for central banks to offer massive liquidity to the markets in order to maintain any form of stability. This liquidity turned out to be something of a sticking plaster that held back the contagion for a period of time, but ultimately proved to be insufficient in its own right. Almost a year after the credit crisis had begun national Governments such as Ireland and Greece found it necessary to offer unconditional guarantees for almost the whole of their banking systems, and this was followed by massive support packages which included, amongst other things, governments taking (or offering to take) significant equity stakes in banks. The extent of the government assistance available has made certain banking institutions more secure for depositors than they have been for some time, despite continuing poor trading performances.

Options for lending cash balances

8. In challenging financial times, and particularly when defaults have occurred at other Local Authorities, it is natural to look at ways of de-risking the loan portfolio. Some of the options available are:

(i) *Lend to the UK Government via the Debt Management Office*

It is possible for Local Authorities to lend to the UK Government via a facility offered by the Debt Management Office (DMO). Whilst this offers undoubted security, the interest rates offered are relatively low – they fully reflect the lack of risk that the lender is taking. The DMO take deposits for up to a maximum of six months, which in itself restricts the options for managing the portfolio, and the rates currently available for

periods of 1 month and over are between 1.0% and 2.0% below current money market rates for lending to high quality counterparties.

Despite the low level of rates paid by the DMO, it would be sensible to use the facility in periods where market risk increases significantly. Given that this report goes on to recommend a significant reduction in the number of acceptable counterparties it may prove necessary to use the DMO at some stage in the future, if many of the other counterparties already have loans that are up to their individual limits.

A DMO facility is currently being set up by Leicestershire, but it is not expected that this will be the central plank of our treasury management activities.

(ii) *Utilise Bradford & Bingley and Northern Rock as counterparties*

Both of these institutions are owned by the UK government and, as a result, have explicit government guarantees. Although they have poor credit ratings in their own rights, there could be a strong argument that the government guarantee should override this fact.

From a practical viewpoint there is no particularly great benefit gained from including them within the list of acceptable counterparties – Bradford & Bingley have not raised funds within the money markets since their nationalisation and Northern Rock only take funding in periods of 3 months and more. The fact that the government could (but undoubtedly won't) withdraw its guarantee with three months notice means that the guarantee is not as 'cast iron' as it might seem, and means that ignoring the other (very poor) credit ratings is difficult to justify.

(iii) Invest in Government Bonds (Gilts)

Although our current policy does not allow us to invest in Gilts, this could easily be amended.

If gilts are held to maturity, the return achieved is known is advance. In the interim period their price fluctuates in the market and there is the possibility of a capital gain or loss, and these gains/losses have to be reflected in the revenue account.

Gilts that have a short date to maturity will have relatively little fluctuation in capital value, but will yield a much lower interest rate than could be achieved by lending cash in the money market – the government guarantee and the highly liquid nature of them are effectively 'paid for' by a lower income yield.

Longer-dated gilts will have a capital value that is much more volatile, and the potential to need to account for capital losses in the financial year that they occur is not ideal for a budget item that has a significant

value. Given the current low-yield on gilts (a gilt maturing in 2055 will yield 3.7% if held to maturity, with 10 year gilt yielding 3.0%) and the amount of issuance that will be required by the Government to fund its spending plans (including assistance to the banking sector), any move into gilts at the present would run the risk of capital losses arising.

The potential for significant capital loss from current price levels does not make gilts an attractive option at present. In order to utilise gilts we would also need to appoint an external investment manager as we do not have the required skills 'in house', and the management fees payable would reduce the net return that we would achieve.

(iv) *Money Market Funds (MMFs)*

Money Market Funds are pooled vehicles which invest in cash and cash-like instruments, and by doing so offer access to skilled cash management and a spread of counterparty risk. In order to maintain their AAA rating (the best available) the MMFs have to comply with certain factors, including a maximum weighted average maturity date, a minimum individual counterparty rating, a (higher) average counterparty rating and a maximum exposure to a single counterparty.

The combination of these factors makes MMFs very secure investments, but the risks are not completely eliminated. Whilst the spread of counterparties within a MMF means that only a relatively small element of the cash invested will ever be lost (as opposed to a market loan, where the risks are all-or-nothing), the minimum criteria acceptable to MMFs is actually below a credit rating that would be acceptable to ourselves. So far, no AAA-rated UK MMF has suffered any capital loss and been forced to repay to clients less than the original sum invested.

Most MMFs are currently de-risking their portfolios as quickly as they can, by investing all new cash flows and any maturing investments in very highly credit-rated institutions for very short periods. The impact of this is to reduce the interest paid, but to improve the security of the capital invested – in the current climate the MMFs have little option to do this, or the cash will be withdrawn and invested elsewhere.

The Council currently uses MMFs to invest, usually as a replacement to short-term loans that are required to mature so that daily cash flows can be paid. There is no intention to change this, but neither is there a strong rationale for using them more widely than we currently do.

(v) *UK Clearing Banks*

The major UK clearing banks retain very high credit ratings although they are on a downward trajectory, as are virtually all of the World's banks. As long as these ratings remain high, they remain very low risk counterparties.

The financial support package that government has given the banks access to – a package that has seen the government take sizeable equity stakes in the likes of RBS and Lloyds TSB/HBOS – comes fairly close to an explicit guarantee that they will receive support in the event of further difficulties.

The nationalisation of Northern Rock and Bradford & Bingley – both relatively small players in comparison to the likes of RBS, Barclays etc. – shows that the government is fully aware of the systemic risks that exist. Given that the Council *has* to bank with one of the clearing banks it is absolutely impossible to eliminate all exposure to this area, although the overall credit ratings make this an unnecessary reaction.

It should be noted that not all UK clearing banks have acceptable credit ratings – Northern Rock/B & B (for example) fell below the acceptable criteria well before their current problems. Simply being a UK clearing bank is not in itself sufficient, as a high credit rating is still required in order to be included in our counterparty list.

(vi) Foreign Banks

The potential losses incurred by local authorities in their dealings with the Icelandic Banks have inevitably meant that the spotlight has been turned squarely on *all* foreign banks. In many cases the foreign banks have as good (or better) a credit rating as the UK clearing banks, so it is necessary to keep a sense of proportionality when considering this issue.

Foreign banks have always needed a credit rating that is at least as good as that required by UK banks, if they were to be included on our counterparty list. We have, however, historically restricted exposure (total loans outstanding and/or loan length) to foreign banks to a lower level than would have been allowed to an equivalently-rated UK bank.

In the current market environment it is felt appropriate to further restrict our potential exposure to foreign banks by insisting on exceptionally high credit ratings and a Sovereign rating (i.e. the credit-worthiness of the National Government) that is as high as it can be (AAA). Whilst this would restrict the counterparty list to only 5 foreign banks, in reality most of the foreign banks on our existing list were not active within the UK market anyway. Other than the loss of some Irish Banks as acceptable counterparties, there will be little practical impact from the tightening of our policy in respect of non-UK banks.

(vii) UK Building Societies

Historically the Council has been willing to accept a lower credit rating for building societies than it would for banks, although the rating still

had to be high – there are currently only 10 building societies on our list of authorised counterparties.

UK building societies generally have lower credit ratings than the major banks, which is partly a function of their smaller size. They are, however, involved in a much narrower range of business and – as long as they stick to these – they are much less prone to significant changes in fortune brought about by either external or internal factors. The historical strength of the building society movement – there has never been a failure – gave added justification to the acceptance of a lower credit rating. The size of the building society was also used to differentiate, with minimum assets of £2.5bn being required to become an acceptable counterparty.

Building societies have undoubtedly suffered in the recent economic climate – the mergers of Derbyshire and Cheshire with Nationwide, for example, were defensive moves designed to protect the members of the two smaller societies. There is, as yet, no evidence that any society has been irretrievably damaged since the credit crisis began, but if house prices fall further and for a longer period than is expected by many commentators there may be problems that arise.

The inclusion of Nationwide Building Society in the list of institutions who can apply for government assistance is probably a recognition that there are a small number of good-sized societies that have the ability to merge with the other medium-sized players. Their inclusion in the scheme can, however, be considered good news for the members of other building societies, and a sign that the government is unlikely to sit back and allow building societies to fail.

In the current financial crisis it is sensible to insist that Building Societies should be considered as an extension of the UK clearing bank system, and that their credit ratings should need to be as good as those UK banks with acceptable ratings, if they are to be retained on our counterparty list. This would leave only Nationwide Building Society as an acceptable counterparty.

Review of Counterparty List

9. The extent to which Local Authorities were exposed to Icelandic banks at the time of their failure has been widely reported, and has understandably led to questions being asked about the ability of councils to safeguard the public money that they hold. It is worth noting that Leicestershire did not have any of the Icelandic banks on its list of acceptable counterparties (and that they have never been on the list), as their credit ratings did not meet our criteria.

10. The Council employs Sector as a treasury management adviser and their 'standard' lending criteria included the Icelandic banks, albeit that the loan period was restricted to a relatively short (3 month) period –

scant consolation if there was a loan in place at the time that they failed. Our own criteria were higher than Sector's, hence the fact that we did not lend to the Icelandic banks – if we had followed Sector's suggested list there is a very high probability that money would have to been lost, as the Icelandic banks were amongst the highest paying counterparties within the market.

11. Despite having lending criteria that are already fairly strict, it is entirely appropriate to review these in the current market environment. It should be noted that this review takes account of the position that the World's financial system is now in – some may consider that an overly-conservative stance is being taken, but there is a distinct possibility that things will get worse before they start to improve. It is entirely possible that the acceptable criteria may be loosened at some stage in the future, as the current strains within the system are reduced, but this is likely to be in years (rather than months) to come. A policy that is risk averse without completely obliterating the interest earned on revenue balances (as, for example, a DMO-only policy would) is sensible in the current environment.

Currently Acceptable Criteria

12. It would be futile to suggest that it would be possible internally to 'judge' the credit-worthiness of any potential counterparty via the use of publicly available financial information such as annual accounts etc. As a result it is necessary to rely on the skills and judgement of those who are best placed to do this – the credit rating agencies. These agencies are able to gain access to the banks' senior management and internal records and, as a result, are capable of forming a subjective and independent judgement on the risks associated when dealing with them. Whilst these credit rating agencies are not perfect – they have been accused of being slow to recognise deteriorating banking fundamentals – they are the best tool available to us.

13. For banks the Council currently uses ratings produced by Fitch to assess credit-worthiness, and the approach is to fit each bank into a matrix depending on their ratings within the individual factors. This matrix effectively dictates the maximum value of loans outstanding and the maximum period that any loan can be lent for – essentially the higher the credit rating, the longer the period and/or the higher amount that can be lent to any counterparty. The matrices differ between UK and overseas banks, with a higher maximum loan amount available for UK institutions.

14. UK building societies carry out a much narrower category of business than most banks do, and some of them have no requirement for a full Fitch rating. As a result the Council has always used Moody's ratings to assess the credit-worthiness of the building societies, and has also differentiated between individual societies in terms of the value of their assets. Those building societies that currently satisfy our requirements

have good credit ratings, but would not (with the exception of Nationwide) satisfy our criteria if they were banks – the differentiation has always been justified on the basis of the lower risks that they take and the historical strength that the building society movement has shown.

Potential Improvements to Process

15. The main reason that Fitch ratings have historically been preferred is that they produce four ratings (short term, long term, individual rating and support rating) compared to Moody's three – it is the support rating (i.e. the probability of external support from a major shareholder or government in the event of difficulties) which is the major differentiating factor. These four factors, when combined, give a very good all-round assessment of financial strength.

16. There is a fifth element to the Fitch ratings that has previously not been considered particularly necessary to take account of, but which circumstances have shown to be an important factor – the rating of the sovereign government in which the bank is domiciled. On the assumption that it is ultimately a national government that will offer support, it is inherent that the government must itself be strong enough to finance the support – the Icelandic Government must have wanted to support its banks, but could not afford to.

17. Banks which have the highest possible short-term (i.e. up to one year), support and sovereign rating are very low risk, especially when these are backed up with good long-term and individual ratings. Restricting the list of acceptable banks to these counterparties is a sensible approach, with differentiation on maximum loan amount and periods being dependent on quite how good the overall ratings are.

18. In order to avoid overexposure to a single overseas economy, it is intended to introduce a maximum exposure amount to all banks within any single overseas country. Whilst the very high sovereign ratings required already give great comfort on the financial strength of the national government, this further control is sensible.

19. There is a possibility that the views of the two main rating agencies (Fitch and Moody's) may differ, despite the fact that they are looking at the same financial institution. It is, therefore, sensible to take account of both Fitch and Moody's ratings and to work on the basis of the lowest rating assigned by either of the agencies. This enhancement, taken together with the use of the sovereign rating, gives significant extra comfort that we are only lending to institutions where the risk of default is very low. Unless an institution has both full Fitch and Moody's ratings they will not be included in the list.

20. It is proposed to increase the importance that is given to the support and sovereign ratings (taken together these are a very powerful tool for

assessing the risks), whilst continuing to only accept counterparties with the best short-term ratings and very high other ratings. The resulting reduction in the number of counterparties available leads to the almost inevitable conclusion that it will be necessary to increase the maximum lending exposure to those institutions with exceptionally high credit ratings – the portfolio has to be placed somewhere, and not increasing these individual limits would lead to sub-optimal lending (large elements to the DMO, for example) without any meaningful compensation in reducing the overall risks involved. An example of this would be an increase in the limit for some UK clearing banks from the current £25m up to £40m.

21. For UK building societies it is proposed to consider them alongside UK banks on a like-for-like basis. It is also proposed that overseas banks will need to have exceptionally high credit ratings to be retained on the counterparty list, and even then they will have a lower maximum loan amount and period than UK institutions.

Maximum Loan Period

22. The current treasury management policy allows term deposits (i.e. ones with a pre-defined maturity date) for a maximum period of three years. In the event, however, that the borrower has the option to repay a loan at his discretion at some date at or before the end of a three year period (referred to generally as a 'callable loan'), the maximum loan period can be five years.

23. Callable loans give the borrower great flexibility in terms of their funding – they can borrow at a known rate for up to the maximum period of the loan (say five years) but at various points can choose to repay – if interest rates are much lower on any of the 'call' dates, they will repay and borrow fresh funds at a lower rate. The reason these deals are attractive to lenders is that the borrower is willing to pay a very healthy premium for these options to repay, so the rate achieved can be very attractive.

24. For the last four years the Council has derived significant benefit from callable loans, and their use has been one of the main reasons why the portfolio has outperformed by as much as it has. Restricting callable loans to a maximum period of three years (so that it is not anomalous with period loans) would have a significant impact onto the rate achieved and would impact onto the level of interest earned. In the current market environment it is, however, considered sensible to restrict the maximum period for all loans to three years.

Impact of Proposed Changes onto Existing Portfolio

25. The changes within the proposed new treasury management policy will mean that a number of existing loans will be with counterparties to whom we will no longer lend. There is nothing that can be done about

this – term deposits have a maturity date that is non-negotiable – but it will make the portfolio appear quite 'risky' until these loans mature. Given that all of the loans within the existing portfolio are to counterparties where a default appears highly unlikely, the Council's current financial position is believed to be fundamentally secure.

26. By the end of the current financial year there will be £30m on loan to counterparties who will not satisfy the proposed new policy. Of this amount, £25m is to 4 different building societies and £5m is to an Irish bank with an explicit Government guarantee. By the end of September 2009 only £10m of these loans (to 2 different building societies) will be outstanding.

Additional Reporting to Members

27. Given the current anxiety around treasury management, a quarterly report on activity will now be produced for both the Scrutiny Commission and Cabinet. The first such report will cover the period ending March 2009, and it is intended that the report will list the Council's exposure to each counterparty and comment on any significant events (portfolio-specific or market-related) that occurred over the previous quarter. This report will give the opportunity to discuss any possible policy changes in the light of, for example, practical difficulties encountered by working with a much-reduced counterparty list.

Summary

28. The fundamental review that has been carried out in respect of the County Council's treasury management policies has led to a number of proposed changes, despite the fact that the existing policy was already relatively risk-averse. These changes are not simply a knee-jerk reaction to losses incurred at other authorities, but do take a realistic approach to the current market difficulties.

29. The proposed changes are not expected to have a particularly material impact onto the level of interest earned, but will undoubtedly diminish the opportunities available. The uncertainty within the current market environment makes this a price well worth paying.

30. In general the proposed changes introduce the dual use of two credit rating agencies, with the lowest one deciding the maximum period and length of loan to any counterparty. They also introduce the use of a sovereign rating and enhance the importance of the support rating, whilst still requiring very high long-term and short-term ratings. Within overseas banks it is proposed that a limit is placed on the total amount of loans that can be outstanding to all banks domiciled in a single country, in order to avoid overexposure.

31. It is proposed that building societies will require credit ratings that are on a par with UK banks, and will be judged on a like-for-like basis with them.

32. The combined impact of these proposals is to reduce significantly the number of potential counterparties. To balance this reduction, it is necessary to increase the maximum sums that can be on loan to acceptable counterparties (i.e. those with exceptionally high credit ratings).

33. The matrix of acceptable credit ratings is included as Appendix A to this report. It is accepted that the quantum of the ratings is difficult for members to assess, given that they are unlikely to be experts in this area, and Appendix B puts individual institutions into the matrix. It should be noted that credit ratings change and that institutions will move around the matrix depending on their last credit rating update.

34. Where separate financial institutions form part of a larger group, the restriction on the whole group will be set at the highest amount for the individual counterparty. For example, Abbey National (proposed £30m limit), Alliance & Leicester (proposed £30m limit) and Banco Santander (proposed £5m limit) are all part of the same group. We will not lend any more than £30m to the whole group, and will not breach the individual limit of Banco Santander – if we were to lend £25m to Abbey National, only a further £5m would be lent to either Alliance & Leicester or Banco Santander (but not both).

<u>Resources Implications</u>

35. Treasury management is an integral part of the County Council's finances. Interest on revenue balances is expected to generate £9m in 2008/09, which is a very meaningful item within the revenue budget. Any proposed actions which may impact onto the level of interest earned are, therefore, important and must be viewed against the risks involved – the loss of any capital is the single most important factor and would severely impact onto the outcome of treasury management activities in both the short and long-term.

<u>Conclusions</u>

36. The current financial conditions – and in particular the failure of the Icelandic Banks – has heightened the scrutiny under which treasury management is placed. It is natural for this to lead to a review of the counterparty list, with a view to deciding whether any lessons can be learnt. The central tenet of the Council's treasury management policy – that security of the sum invested is of paramount importance – has never, and will never, change.

37. It is intended to ask the Cabinet is to approve the matrix attached as Appendix A as the criteria that will decide on the acceptability of

individual counterparties, as well as the maximum loan length and the total sum outstanding to any counterparty at a point in time.

Recommendation

38. The Commission is requested to indicate what comments, if any, it wishes to make on the proposed revised criteria required for inclusion on the list of authorised counterparties.

Equal Opportunities Implications

39. None.

Circulation Under Sensitive Issues Procedure

None.

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Background Papers

Report to County Council on 21st February 2008 – 'Medium Term Financial Plan': Appendix N 'Treasury Management Strategy Statement and Annual Investment Strategy 2008/09'.

Appendix A

Matrix for UK Banks and Building Societies

Maximum Sum Outstanding	£40m	£30m	£15m
Maximum Loan Period	3 years	3 years	2 years
Minimum Fitch Support Rating	1	1	1
Must at least match **all** of the following:			
Fitch Short Term Rating	F1+	F1+	F1+
Moody's Short Term Rating	P-1	P-1	P-1
Fitch Long Term Rating	AA	AA-	AA-
Moody's Short Term Rating	Aa2	Aa3	Aa3
Fitch Individual Rating	B/C	B/C	C
Moody's Financial Strength Rating	C+	C+	C

Matrix for Overseas Banks

Maximum Sum Outstanding	£10m	£5m
Maximum Loan Period	1 year	1 year
Minimum Fitch Sovereign Rating	AAA	AAA
Minimum Fitch Support Rating	1	1
Must at least match **all** of the following:		
Fitch Short Term Rating	F1+	F1+
Moody's Short Term Rating	P-1	P-1
Fitch Long Term Rating	AA+	AA
Moody's Short Term Rating	Aa1	Aa2
Fitch Individual Rating	B	B
Moody's Financial Strength Rating	B	B

Maximum Country exposure: AAA sovereign rating = £15m

Money Market Funds

AAA-rated only
Maximum amount in any single fund = £25m
Maximum amount in all Money Market Funds = £75m

Debt Management Office (DMO)

No restriction on loan amounts or periods. In the event that the maximum loan length is extended beyond the current 6 month period, no loan will have a maturity above 3 years.

Appendix B

Counterparty list produced by proposed matrices (as at end of December 2008)

UK Banks

Maximum Sum Outstanding	£40m	£30m	£15m
Maximum Loan Period	3 years	3 years	2 years
	Bank of Scotland (1)	Abbey National (2)	
	Barclays	Alliance & Leicester (2)	
	HSBC	Clydesdale	
	Lloyds TSB (1)	Nat West (3)	
		Nationwide Building Society	
		Royal Bank of Scotland (3)	

Overseas Banks

Maximum Sum Outstanding	£10m	£5m
Maximum Loan Period	1 year	1 year
	Bank Nederlandse Gemeenten	Royal Bank of Canada
	Rabobank International	BNP Paribas
		Banco Santander (2)

(1) Bank of Scotland (currently part of HBOS) and Lloyds TSB will soon be legally part of the same bank – the limit will be £40m to the whole group.

(2) Abbey National, Alliance & Leicester and Banco Santander are part of the same group – a £30m limit will apply to the whole group.

(3) Nat West and Royal Bank of Scotland are part of the same group – the limit will be £30m for the whole group.