CORPORATE GOVERNANCE COMMITTEE – 24TH NOVEMBER 2014

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

RECOMMENDED CHANGE TO TREASURY MANAGEMENT POLICY IN RESPECT OF THE LENDING OF SURPLUS BALANCES

Purpose of the Report

1. To seek the views of the Corporate Governance Committee about recommended changes to the method by which the acceptability of counterparties to whom surplus balances can be lent is decided, and to seek views in respect of the inclusion of Certificates of Deposit (CDs) as an acceptable loan instrument. These views will be included in a future report to the Cabinet, with the ultimate aim of included any agreed changes in the Annual Investment Strategy that will become effective on 1st April 2015 following approval by the Council.

Background

2. The Authority has a policy in respect of the minimum credit ratings that are required in order that loans can be made to certain counterparties, and this policy dictates both the maximum amount that can be lent to any counterparty and the maximum period that a loan can be placed for.

3. Leicestershire's credit rating requirements are high, which is a reflection of the fact that the security of the sum invested is considered to be of the utmost importance. Leicestershire has employed treasury management advisors (Capita Asset Services, formerly known as Sector Treasury Services) for almost 20 years and for most of this time the credit ratings that were required in order to become an acceptable counterparty have been broadly similar to those suggested by the advisor, although Leicestershire has always had a slightly more risk-averse approach. Until the financial crisis this meant that a relatively small number of lower – but still highly – rated institutions were not included in Leicestershire's list but were included in that produced by the advisor. 'Losing' these slightly higher risk counterparties was considered to have no meaningful impact on the management of the portfolio and the level of interest earned, so the additional (small) risk was deemed unnecessary.

4. Following the financial crisis Leicestershire tightened up its required credit ratings, at a time that the credit ratings of financial institutions fell. The impact was that the number of acceptable counterparties reduced

very significantly, which was felt to be appropriate given the uncertainty that surrounded the financial industry at that time and for a number of years afterwards. Other than a small nuance to the required criteria that allowed UK part state owned banks to remain on the counterparty list with marginally lower ratings than were needed without state ownership, Leicestershire's requirements have remained constant since the changes that were considered necessary as a result of the financial crisis.

5. The current list of acceptable counterparties is very small and consists of Lloyds Banking Group (who, under the current policy, would probably be removed from the list if there was a further share sale by the Government), HSBC, local authorities, money market funds and the Government (via either the Debt Management Office or Treasury Bills).

6. Given the level of balances held – an average of £180m and often over £200m – there are occasions when lending the balances at an acceptable level of interest becomes a problem. This should not, in itself, suggest that a change of policy is appropriate as exposing the monies to an unacceptable level of risk simply to generate additional interest is clearly not sensible. There has, however, been a significant change in the nature of financial institutions in recent years – including being subject to regular stress tests, much more intense regulation and the requirement to hold significantly more capital, both in itself, but also compared to an institution's risk weighted assets – and it is now considered appropriate to take a different approach to the level of credit ratings that are considered acceptable by the Authority.

Approach to deciding acceptable counterparties

7. Leicestershire's approach to selecting acceptable counterparties has stood the Council in good stead for many years – avoidance of the Icelandic Bank default was not luck, it was because these banks never had sufficiently high credit ratings to be acceptable to the Council. It is, however, a fairly one-dimensional approach as it relies almost exclusively on credit ratings as the factor that determines acceptability. There are some other factors taken into account, such as the credit rating of the home nation of the counterparty and a number of financial market risk metrics, but the credit ratings assigned by rating agencies remain the key factor.

8. The Council's treasury management advisors have a far more holistic approach to producing a list of acceptable counterparties, although the credit ratings of individual institutions remain the backbone of it. Other factors include a macroeconomic assessment, the rating of the home nation, outlook notifications issued by the rating agencies and the level of Credit Default Swaps for the counterparties. Credit Default Swaps set a price for 'insuring' against the default of a counterparty and are a market assessment of this risk; as they are actively traded they reflect institution-specific issues relatively quickly.

9. Leicestershire does not have the expertise or resource to be able to effectively assess many of the ‘softer’ issues around counterparty quality. The advisor’s approach undoubtedly gives the Council a more rounded assessment than anything that could be done using in-house resources, and it seems sensible that the advice of the Council’s advisors is used when setting a list of acceptable counterparties. It is felt that their methodology has the end result of a counterparty list that is very low risk, but is sufficiently flexible to take account of changes to counterparty quality.

10. Another matter that has become apparent in recent years is that the credit rating agencies continue to adapt their methodologies and to introduce/withdraw individual elements of their ratings. Capita are able to evaluate what impact these changes will have and to adapt their methodology accordingly, but this is far more difficult to implement if the Council continues to retain its own methodology.

<u>Impact of switching to Capita’s methodology</u>

11. One reason that there are no overseas banks on Leicestershire’s list of acceptable counterparties is that the current policy requires overseas banks to have a higher credit rating than those which are acceptable for UK banks. Capita’s methodology does not differentiate between UK and overseas banks, and also includes an acceptable level of credit rating that is slightly lower than that used by Leicestershire. The lowest acceptable credit rating used by Capita is still very high, so the marginal decrease is not considered to bring any meaningful increase in overall risk – their current list still consists exclusively of highly-rated, lower-risk, financial institutions.

12. The list of acceptable counterparties produced by Capita is considerably longer than Leicestershire’s current list. The vast majority of these additional counterparties are best considered as ‘theoretical’ counterparties only – the list includes all authorised deposit takers in the UK that meet the required criteria, but in reality the majority are not active within money markets or pay such low rates that they are not attractive. The reality is that there will be no more than a dozen additional counterparties that are likely to be useful to the Council.

13. One impact of an expanded counterparty list is that there will be less reliance on the use of Money Market Funds. These are pooled funds that invest in cash and cash-like instruments and are actively managed by specialists in the market. Whilst Leicestershire only invests in AAA-rated money market funds, the “AAA”-rating is somewhat misleading as it gives the impression of a risk-free investment.

14. Credit ratings for Money Market Funds are assigned using a different basis than the credit ratings given to countries or individual financial institutions – an AAA-rated Money Market Fund does not mean that

there is a lower risk of capital loss than (for example) lending to the UK Government. In order to maintain an AAA-rating a Money Market Fund has to fulfil certain quantitative criteria; these include a maximum maturity date for any single instrument, a maximum weighted average maturity date, a minimum acceptable credit rating for any counterparty and a maximum exposure to any single counterparty.

15. Assigning an AAA-rating to a pooled fund in which hardly any of the underlying instruments are AAA-rated may seem perverse, but it is a quirk of the rating system rather than a deliberate attempt to mislead. The reality is that the significant diversification and the expert, and active, management make Money Market Funds very low risk investments. If an individual counterparty does default only a small proportion of capital within a Fund could be at risk, unlike a deposit with a single counterparty where the whole investment is at risk. There has never been an instance of an AAA-rated Money Market Fund not repaying 100% of capital in Europe, so their low-risk nature has been borne out in reality.

16. A by-product of an expanded list of acceptable counterparties is that there will almost undoubtedly be lower amounts invested at any point in time with Money Market Funds. The current policy effectively ‘forces’ significant sums to be held in these products; the maximum permitted exposure is £125m, with a maximum for each individual fund of £25m, and the amount actually invested in them is usually between £100m - £125m. Whilst these funds are felt to be a low risk investment, diversification away from them will lower overall risks and also potentially increase the interest earned.

17. Money Market Funds are very much focussed on the ultra-short end of the yield curve and this is reflected in the fact that their returns are typically close to that of overnight to seven day maturities. As such, diversification away from them will allow the consideration of a wider range of investment maturities that should produce a more appropriate level of return given the Council’s cash flow profile. The use of a wider range of investment maturities will still be dependent on market conditions, the outlook for interest rates and the maximum durations applied to acceptable counterparties.

Introduction of ability to invest in Certificates of Deposit

18. Certificates of Deposit (CDs) are tradeable cash investments that are issued by financial institutions. They have a set maturity date and rate of interest that is payable at maturity. They carry exactly the same security risks as a cash deposit (i.e. in both instances the lender is deemed an unsecured depositer), but have the added advantage that they can be bought and sold at any point up to maturity.

19. CDs have not previously held any great attraction to the Council, hence they are not currently an acceptable instrument within the treasury management policy. The lack of attraction has been for two reasons – their 'tradeability' makes them more attractive to some investors and this often manifests itself in a slightly lower rate of interest than an equivalent term deposit, and the cost of buying/selling them eats into returns (a custodian has to be used).

20. Recent years have seen the emergence of some counterparties that are not active in the cash deposit market, but are active in the issue of CDs at interest levels appropriate to their perceived security. There have also been occasions when CDs have actually been available at rates that are above equivalent cash deposits. This change in the CD market has not required any request to add CDs as an acceptable instrument as the counterparties in question were not on the existing list of acceptable counterparties. An expansion of the list will possibly bring some of these counterparties onto the list, so a change would be desirable.

21. There would always be a preference for making cash deposits to a counterparty rather than buying a CD from the same counterparty, unless there were compelling (usually return-based) reasons for buying a CD. The addition of certificates of deposit as an acceptable instrument would, however, bring some useful flexibility in managing the loan portfolio. The intention would be that all CDs are held to maturity, but specific circumstances may lead to sales prior to maturity.

22. For the avoidance of doubt, CDs could only be held if they were issued by counterparties that were on the authorised counterparty list. The maximum duration and amount would be in line with those that are relevant to the counterparty in question, and in terms of ensuring that limits are not breached a CD would be simply considered to be a cash investment with that counterparty. If the counterparty was removed from the authorised list while a CD issued by them was held, consideration would be given to selling the CD to remove the exposure but a sale would not be automatic. A view would be taken on the risks associated with continuing to hold the CD and this would be considered against any potential loss that would be incurred in the event of a sale.

<u>Possible changes to list produced by Capita</u>

23. Whilst it is recommended that the methodology used by Capita is adopted by the Council – in effect, that Leicestershire begins to use their standard list of authorised counterparties as the basis of its list – there are some changes that would be considered reasonable, and which would result in Leicestershire's list being slightly more risk averse than the standard Capita one. These would be that the maximum loan period should be one year (Capita have a small number of counterparties that are included for a suggested period of up to two

years), and that those counterparties for whom Capita suggest a maximum maturity of 100 days are excluded; including this handful of counterparties adds an element of additional risk (albeit a small amount) for little extra return. Another way of looking at this last point is that if Capita are unwilling to recommend a loan of over 100 days, the County Council should err on the side of caution given that any lost opportunities are likely to bring a negligible extra return.

24. It is also suggested that there should be a few ‘housekeeping’ rules taken into account:

- Sovereign rating is already part of the Capita methodology, but a maximum total exposure to all institutions from any overseas country should be set at £30m – so, for example, only a total of £30m could be on loan to all Australian banks despite the total of their individual limits being £70m;

- There are some counterparties where both a parent company and a subsidiary are licensed deposit takers in the UK. Where this is the case a ‘group limit’ should apply, and this should be set at the limit that is given to the parent company;

- There should continue to be differentiation between UK and overseas banks, but only in terms of the amounts that can be lent to them and not in the maximum duration of loans.

25. Capita do not recommend maximum amounts that should be lent to a counterparty as they believe that this should be adapted to both the size and the risk tolerances of individual clients, and should be for the client to decide. Having considered this issue the following limits are recommended:

- If the counterparty is on the list as a ‘special institution’ (i.e. they have a meaningful level of UK government ownership), the limit should be £50m;

- If the counterparty is a ‘normal’ institution and the maximum period is 1 year: £30m for UK institutions, £15m for overseas institutions

- If the counterparty is considered acceptable for 6 months: £20m for UK institutions, £10m for overseas institutions.

26. The principles laid out in this report – taking the standard Capita list of acceptable counterparties, ‘tweaking’ it slightly for matters such as restricting loans to a maximum of 1 year and excluding a small number of counterparties that are at the lowest end of Capita’s list – give a strong and defined process for creating a list, and the list will only include counterparties with strong credit ratings (and, therefore, low credit risks).

27. This revised process will create extra flexibility and will help to enhance returns modestly – in the current market circumstances it is probable that that the enhanced return will be between £150,000 and £250,000 p.a. The expanded list does not create any meaningful increase in risk. A full list that this change in process will create (based on credit ratings at 24th October 2014) is attached, with counterparties that are expected to actually be attractive highlighted.

Summary

28. Leicestershire's current method of producing a list of acceptable counterparties to whom loans can be made has worked well for many years, but changes within the market (including the increasingly more active and nuanced ways in which the credit rating agencies allocate ratings) run the risk of making these methods obsolete and too one-dimensional. The methods used by our treasury management advisors, Capita Asset Services, take more aspects of financial markets into account and are more advanced than the Authority's current methods. Capita's methodology is followed by the vast majority of their clients; given their dominant position as treasury advisors to Local Authorities, their methodology is very widely accepted.

29. Whilst there is merit to making small changes to Capita's methods, the changes considered prudent are fairly minor. Capita's methodology produces a list of counterparties that are high quality, and low risk.

30. There is no intention of changing Leicestershire's methods until 1st April 2015, by which time these changes will have been considered by the Cabinet and the Council. This report is the starting point of this consideration.

Resource Implications

31. Treasury Management Policy should not be based on a desire to maximise interest earned, and security of the sum invested should always be the main consideration. The proposals highlighted in this report are not based on a desire to generate more interest but the expectation is that (if fully adopted) they will lead to an extra £150,000 - £250,000 interest being earned in each year, without any meaningful increase in the overall risk.

Equality and Human Rights Implications

32. There are no discernable equal opportunity implications arising from this report.

Recommendation

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

Background Papers

None.

Circulation under the Local Issues Alert Procedure

None.

Appendix

List of acceptable counterparties using recommendations included in the report to the Corporate Governance Committee

Officers to Contact

Chris Tambini, Assistant Director (Strategic Finance and Property)
Telephone 0116 3056199, email: chris.tambini@leics.gov.uk

Colin Pratt, Investment Manager
Telephone 0116 3057656, email: colin.pratt@leics.gov.uk

APPENDIX

List of acceptable counterparties using recommendations included in report to Corporate Governance Committee on 24th November 2014

(Highlighted counterparties are those that are currently active within money markets and paying rates that are competitive)

1 year

Lloyds Banking Group plc	United Kingdom	£50m
Royal Bank of Scotland Group plc	United Kingdom	£50m
Bank of New York Mellon (International) Ltd (1)	United Kingdom	£15m*
HSBC Bank plc (2)	United Kingdom	£30m*
National Bank of Abu Dhabi	Abu Dhabi (U.A.E)	£15m
Australia and New Zealand Banking Group Ltd	Australia	£15m
Commonwealth Bank of Australia	Australia	£15m
National Australia Bank Ltd	Australia	£15m
Westpac Banking Corporation	Australia	£15m
Bank of Montreal	Canada	£15m
Bank of Nova Scotia	Canada	£15m
Canadian Imperial Bank of Commerce	Canada	£15m
Royal Bank of Canada	Canada	£15m
Toronto Dominion Bank	Canada	£15m
Nordea Bank Finland plc (3)	Finland	£15m*
Pohjola Bank	Finland	£15m
DZ Bank AG (Deutsche Zentral-Genossenschaftsbank)	Germany	£15m
Landwirtschaftliche Rentenbank	Germany	£15m

NRW.BANK	Germany	£15m
The Hong Kong and Shanghai Banking Corporation Ltd (2)	Hong Kong	£15m*
Banque et Caisse d'Epargne de l'Etat	Luxembourg	£15m
Clearstream Banking	Luxembourg	£15m
Bank Nederlandse Gemeenten	Netherlands	£15m
Cooperatieve Centrale Raiffeisen Boerenleenbank BA (Rabobank Nederland)	Netherlands	£15m
Nederlandse Waterschapsbank N.V	Netherlands	£15m
Qatar National Bank	Qatar	£15m
Samba Financial Group	Saudi Arabia	£15m
DBS Bank Ltd	Singapore	£15m
Oversea Chinese Banking Corporation Ltd	Singapore	£15m
United Overseas Bank Ltd	Singapore	£15m
Nordea Bank AB (3)	Sweden	£15m*
Svenska Handelsbanken AB	Sweden	£15m
Bank of New York Mellon, The (1)	United States	£15m*
HSBC Bank USA, N.A. (2)	United States	£15m*
JPMorgan Chase Bank NA	United States	£15m
Northern Trust Company	United States	£15m
State Street Bank and Trust Company	United States	£15m
U.S. Bancorp	United States	£15m
Wells Fargo Bank NA	United States	£15m

6 Months

Abbey National Treasury Services plc (4)	United Kingdom	£20m*
Barclays Bank plc	United Kingdom	£20m
Cater Allen (4)	United Kingdom	£20m*

Citibank International Plc (5)	United Kingdom	£10m*
Credit Suisse International (6)	United Kingdom	£10m*
Merrill Lynch International	United Kingdom	£20m
Nationwide BS	United Kingdom	£20m
Santander UK plc (4)	United Kingdom	£20m*
Standard Chartered Bank	United Kingdom	£20m
Sumitomo Mitsui Banking Corporation Europe Ltd	United Kingdom	£20m
UBS Ltd (7)	United Kingdom	£10m*
Macquarie Bank Limited	Australia	£10m
BNP Paribas Fortis	Belgium	£10m
KBC Bank NV	Belgium	£10m
National Bank of Canada	Canada	£10m
BNP Paribas	France	£10m
Credit Agricole Corporate and Investment Bank	France	£10m
Credit Industriel et Commercial	France	£10m
Credit Agricole SA	France	£10m
BayernLB	Germany	£10m
Deutsche Bank AG	Germany	£10m
Landesbank Baden Wuerttemberg	Germany	£10m
Landesbank Berlin AG	Germany	£10m
Landesbank Hessen-Thueringen Girozentrale (Helaba)	Germany	£10m
ING Bank NV	Netherlands	£10m
DnB Bank	Norway	£10m
Arab National Bank	Saudi Arabia	£10m
Riyad Bank	Saudi Arabia	£10m
Skandinaviska Enskilda Banken AB	Sweden	£10m

Swedbank AB	Sweden	£10m
Credit Suisse AG (6)	Switzerland	£10m*
UBS AG (7)	Switzerland	£10m*
Bank of America, N.A.	United States	£10m
BOKF, NA	United States	£10m
Citibank, N.A. (5)	United States	£10m*

(1) Maximum total position and duration for Bank of New York Mellon and subsidiaries is £15m for 1 year – based on US parent.

(2) Maximum total position and duration for HSBC and subsidiaries is £30m for 1 year – based on UK parent.

(3) Maximum total position and duration for Nordea Bank and subsidiaries is £15m for 1 year – based on Swedish parent.

(4) Maximum total position and duration for Santander Bank UK and subsidiaries is £20m for 6 months – based on UK parent.

(5) Maximum total position for Citibank and subsidiaries is £10m for 6 months – based on US parent.

(6) Maximum total position for Credit Suisse and subsidiaries is £10m for 6 months – based on Swiss parent.

(7) Maximum total position for UBS and subsidiaries is £10m for 6 months – based on Swiss parent.