REPORT TO	DATE OF MEETING
Council	30 September 2015

Report template revised July 2012

SOUTH RIBBLE BOROUGH COUNCIL

forward with South Ribble

SUBJECT	PORTFOLIO	AUTHOR	ITEM
Review of Investment Counterparties 2015/16	Finance & Resources	M L Jackson	10

1. SUMMARY AND LINK TO CORPORATE PRIORITIES

To review the list of Financial Institutions and Investment Criteria approved by the Council on 4 March 2015. Council resolved that a review of Investment Counterparties should be presented to Governance Committee during 2015/16. This report is that review.

2. RECOMMENDATIONS

Governance Committee is asked to note the report.

Governance Committee is asked to recommend that Council approves a revised list of Investment Counterparties for the remainder of 2015/16, as presented as a table in section 7 of the report.

3. DETAILS AND REASONING

The Council's current Investment Strategy was developed in the context of the banking crisis of 2008, and had the objective of ensuring security of investments in a very volatile market. The banking sector has now stabilised to a considerable extent, and the proposals in this report, if approved, would allow the Council to make use of additional investment opportunities, while ensuring that security and liquidity are given priority over the yield achievable.

The list of Investment Counterparties need not be fixed for an entire financial year. Though the tendency has been for Council to approve the list once a year at the budget setting meeting, the creditworthiness of financial institutions can vary and needs to be reflected in investment practices. Where banks have fallen into a lower category of creditworthiness, for instance when the Lloyds Banking Group ceased to be regarded as part-nationalised as a result of the process of selling the Government's shares, Lloyds and Bank of Scotland dropped out of the part-nationalised category straight away. However, there is not currently a process for increasing the maximum period of limit per institution when creditworthiness improves.

The report on this agenda reviewing treasury management activity for the year to date indicates that cash balances available to invest have peaked at £33m, which was higher than anticipated. As a consequence, more use has been made of the Debt Management Office which, though secure and liquid, offers a yield of only 0.25%. The effect has been that the average rate of interest achieved for the year to date has been less than bank rate, though more than the benchmark 7-day LIBID rate.

This report summarises the review of investment options with the view of proposing an updated list of Investment Counterparties, which would tend to achieve a higher yield without sacrificing security or liquidity.

4. STATUTORY GUIDANCE

An edited version of the DCLG's Guide on Local Authority Investments is presented in Section 1 of the Background Papers. Presentation has been changed so that the DCLG's own informal commentary follows each paragraph of the guidance, to aid readability and understanding.

The aim of the Investment Strategy approved in March 2015 was to ensure that all investments qualified as specified investments, being made in sterling, for less than 12 months, with a high credit quality body, or the Government or other local authorities. The Council's current Investment Strategy for 2015/16 complies with the DCLG Guidance, but includes restrictions to investment options not required by the DCLG Guidance such as limiting term deposits with UK banks (other than the part-nationalised Royal Bank of Scotland group) to three months maximum. Where credit quality indicates suitability, investments could be placed with UK-incorporated banks up to one year and still be classified as specified investments in compliance with the guidance.

5. BANK OF ENGLAND STRESS TESTING OF UK BANKING SYSTEM

In March 2013, the Financial Policy Committee (FPC) recommended that regular stress testing of the UK banking system should be developed to assess the system's capital adequacy. In a Discussion Paper published in October 2013, the Bank of England (BOE) set out proposals for the main features of a framework for annual and concurrent stress-testing of the UK banking system.

The BOE will stress test the system annually. The inaugural stress test results were published on 16 December 2014, and explored vulnerabilities stemming from the UK household sector in particular, reflecting the Financial Policy Committee's assessment of the main domestic risks to financial stability at that time. In the first stress test, eight UK banks and building societies were assessed by the Prudential Regulation Authority (part of the BOE). HSBC, Barclays, Santander, Standard Chartered, and Nationwide all passed. The Co-operative Bank failed the stress test. Lloyds Banking Group and the Royal Bank of Scotland were found to be at risk in the event of a "severe economic downturn".

The BOE published the key elements of the 2015 stress test and accompanying guidance on 30 March 2015. Only a minority of banks and building societies are covered by the stress test, which means that several banks considered to be of high credit quality are not tested. The 2015 stress test will cover only seven major UK banks and building societies: Barclays, HSBC, Lloyds Banking Group, Nationwide, Royal Bank of Scotland, Santander UK and Standard Chartered. This is the same as in 2014, though the Co-operative Bank has been omitted. The 2015 stress test will assess the resilience of the UK banking system to a deterioration in global economic conditions. The results of the 2015 stress test will be published in quarter four of 2015.

It is likely that the results of the 2015 stress test will feed into the ratings prepared by the three credit rating agencies, and therefore Capita Asset Services' creditworthiness advice.

6. TRENDS IN DIVERSIFICATION OF LOCAL AUTHORITY INVESTMENTS

Room151 web site has reported that local authority investments with banks and building societies have fallen to just over half of total investments (51.8% - source DCLG), compared to almost three quarters in 2009. The largest shifts were to treasury bills, and to money market funds (MMFs).

Although a smaller part of the market, investment in Certificates of Deposit (CDs) rose by more than 60% in the past year. A CD is similar to a fixed deposit, but with the advantage that it can be sold on to maintain liquidity. CDs can offer a better rate of return than bank deposits, and some banks and building societies are not accepting deposits at present.

A survey due to be released at September's Local Authority Treasurers' Investment Forum is set to show that half of local authorities have held CDs in the past twelve months, and that they are second only to MMF investments in terms of alternatives.

7. ADVICE OF TREASURY MANAGEMENT ADVISERS AND INTERPRETATION FOR REVISED INVESTMENT COUNTERPARTIES LIST

Capita Asset Services (CAS) has reviewed the Council's recent investments, as presented in Appendix A to this report, in order to compare risk (security/liquidity) with reward (yield). The table in Appendix A shows the Council's investment portfolio at the time of the review, which totalled £33.5m. The graph shows the rate of return compared to other CAS clients.

All of the investments were in the "yellow" (up to five years) or "red" (up to six months) categories, though the current Investment Strategy restricted many investments to shorter periods than the maximum recommended by CAS. In brief, CAS concluded that the investments were generally low risk, but that the rate of return (0.44%) was lower than average for CAS clients, the reason being the need to place deposits with the DMO at 0.25% because investments with other counterparties were at the maximum permitted by the Investment Strategy.

CAS' advice is that the Council could increase the yield from investment of its cash balances by extending the range of counterparties and investment options, without sacrificing security. The CAS suggestions and the proposed interpretation by this Council are discussed in the following paragraphs.

CAS provides weekly credit rating lists in which suggested investment durations are provided for the guidance of their clients. Section 2 of the Background Papers explains the methodology behind the recommendations, and provides additional information about factors taken into account in arriving at the recommendations in this report.

The Council should continue to apply the creditworthiness service provided by CAS.

CAS advise that their service employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's. The credit ratings of counterparties are supplemented with the following overlays:

- credit watches and credit outlooks from credit rating agencies;
- CDS spreads to give early warning of likely changes in credit ratings;
- sovereign ratings to select counterparties from only the most creditworthy countries.

This modelling approach combines credit ratings, credit watches and credit outlooks in a weighted scoring system which is then combined with an overlay of CDS spreads for which the end product is a series of colour coded bands which indicate the relative creditworthiness of counterparties. These colour codes are used by the Council to determine the suggested duration for investments and are therefore referred to as durational bands. The Council is satisfied that this service will continue to provide a high level of security for its investments. It is also a service which the Council would not be able to replicate using in-house resources.

The CAS durational bands are as follows:

- Yellow 5 years (credit score 1)
- Dark pink 5 years for Enhanced money market funds (EMMFs) (credit score 1.25)
- Light pink 5 years for Enhanced money market funds (EMMFs) (credit score 1.5)
- Purple 2 years (credit score 2)
- Blue 1 year (only applies to semi-nationalised UK Banks) (credit score 3)
- Orange 1 year (credit score 4)
- Red 6 months (credit score 5)
- Green 100 days (credit score 6)
- No colour not to be used (credit score 7+)

The Council's implementation of the bands is presented in the revised Investment Counterparties table below.

Sections 3 to 7 of the Background Papers list all UK incorporated banks and building societies, plus other non-UK banks monitored by CAS.

<u>Local Authorities</u>

The CAS Risk Bands table includes local authorities in the "yellow" band, which has a suggested maximum investment duration of five years.

Investments with UK local authorities may be considered low risk, so it is proposed that the total that can be invested with another local authority is increased to £4m for a maximum period of one year, which is the current duration.

<u>UK-incorporated Institutions</u>

Each council must make its own decisions about creditworthiness and investments. The proposed revised Investment Counterparties list takes account of suggestions by Capita Asset Services, which are believed to be robust. The revised list would define investment counterparties by their category and creditworthiness rather than by name, which could mean that some banks or building societies would move on or off the list from time to time.

It is recommended that the category 'Independent UK Institutions' is redefined as 'UK-incorporated Institutions'. This would mean that some banks with a foreign parent would be added to the counterparty list, but they would be used only if their creditworthiness was as good as UK-owned banks.

Investments would be placed for 3, 6, or 12 months, as appropriate, being based on the recommendations of the Capita Asset Services' creditworthiness system. The maximum period per institution would not be set for a whole financial year, but would be monitored throughout the year and would vary to take account of any changes to the creditworthiness of an institution.

Deposits would not necessarily be placed regularly with the additional institutions. Some institutions set minimum investments greater than the Council would wish to deposit. Some institutions offer low interest rates, but it may be worth using them provided that rates offered are higher than the 0.25% available from DMO. Not all of the institutions are accepting local authority investments at present.

It is also recommended that the limit for investments be increased to £5m per partly-nationalised UK banking group and £4m per other UK-incorporated institutions or groups. If several banks are within a group, they would be treated as one counterparty for the purpose of limiting exposure.

<u>Non-UK Banks</u>

CAS monitor a number of non-UK banks and suggest maximum investment periods based on the rating methodology. Those banks incorporated in the European Economic Area (EEA) which are authorised to accept deposits from UK branches are listed in Section 4 of the Background Papers. The list identifies those monitored by CAS (18), and the 56 banks which are not monitored. Section 5 of the Background Papers lists 81 banks incorporated outside the EEA which are authorised to accept deposits from UK branches. Of these, 24 are monitored weekly by CAS. Suggested durations are provided by CAS for 12 other non-UK banks, as listed in Section 6 of the Background Papers. In some cases, interest rates offered are better than those available from UK-registered counterparties.

It is recommended that high credit quality (based on CAS' creditworthiness system) non-UK banks should be added to the list of Investment Counterparties, subject to a limit of £3m per institution and £6m in total.

Certificates of Deposit (CDs)

CAS suggest use of Certificates of Deposit (CDs) with high quality counterparties should be considered. CDs issued by UK-registered institutions could be used in addition to term deposits and call accounts. They are a negotiable form of fixed deposit, but they do not have to be held to maturity. The Council could realise the cash by selling into an active secondary market, which might be required if a counterparty was downgraded and no longer fitted within the approved investment parameters, or if the cash was required more urgently than originally intended. A custodian facility is required to purchase CDs, and this service is offered by various brokers.

It is recommended that Certificates of Deposit should be included as an investment option, but that they would be taken considered part of the maximum value that could be invested in a bank or group.

Enhanced Money Market Funds/Enhanced Cash Funds

Currently the Council places deposits in high credit quality Money Market Funds (CNAV – Constant Net Asset Value). CAS highlight the benefits of the use of Enhanced Money Market Funds / Enhanced Cash Funds (VNAV – Variable Net Asset Value). Such Funds are designed to produce an enhanced return, and inevitably this involves greater risk (whether credit, interest rate, or liquidity) than the CNAV MMFs currently used by the Council. This does not necessarily mean that there is a reduction in credit quality, but the funds can produce more volatile returns.

Unlike the CNAV MMFs being used at present, VNAV EMMFs are not instant access. Most of the Funds are T+2 or T+3, which means that there is a delay of two or three days to get money back after making a withdrawal request.

It is recommended that these Funds are included on the revised Investment Counterparties list. A detailed review of each Fund would be undertaken as part of the initial investment decision process. For the remainder of 2015/16, deposits in EMMFs should be subject to a maximum of £3m per Fund and £6m in total. This could be reviewed when the Investment Strategy for 2016/17 is presented for approval.

Property Funds

For longer-term cash balances, higher rates of return could be achieved by investing in Property Funds. CAS offer a Property Fund Selection Service, to help to select appropriate Funds; and a Monitoring Service. These additional services would be chargeable.

Property Funds are most appropriate for cash balances that can be invested for several years. Rates of return are attractive, potentially exceeding 5%, but the value of the sum invested is not guaranteed.

CAS advise that the use of these instruments can be deemed capital expenditure, and as such will be an application (spending) of capital resources. The Council would seek guidance on the status of any Fund it may consider using. Appropriate due diligence would also be undertaken before investment of this type is undertaken. Funds classed as revenue could be used as Investment Strategy options, whereas any investments deemed to be capital expenditure would require identification of the resources to be applied, and approval of budget provision. CAS also suggest setting an initial maximum limit of £2m for Property Fund investments.

Revised List of Investment Counterparties

The revised list of Investment Counterparties, if all recommendations are accepted, would be as presented in the following table:

Investment Counterparties 2015/16

Category	Institutions	CAS Colour Code	Maximum Period	Limit per Institution
Banks & Building Societies: Call Accounts /Term Deposits / Certificates of Deposit (CDs)				
Government related/guaranteed	DMADF (DMO) UK Local Authority	Yellow Yellow	6 months 1 year	Unlimited £4m per LA
UK part-nationalised institutions	Royal Bank of Scotland group	Blue	1 year	£5m per group
UK-incorporated Institutions	UK banks and building societies of high credit quality	Orange Red Green	1 year 6 months 3 months	£4m per group (or independent institution)
Non-UK Banks	Non-UK banks of high credit quality	Orange Red Green	1 year 6 months 3 months	£3m per group (or independent institution); £6m in total for this category
Money Market Funds				
Money Market Funds (CNAV)	MMFs of high credit quality - AAA rated		Instant access	£4m per fund
Enhanced Money Market Funds (VNAV)	EMMFs of high credit quality - AAA rated		T+2 or T+3	£3m per fund; £6m in total for this category
Property Funds				
Property Funds	Specific Funds to be selected based on CAS guidance & undertaking due dilligence checks			£2m in total for this category

8. WIDER IMPLICATIONS

In the preparation of this report, consideration has been given to the impact of its proposals in all the areas listed below, and the table shows any implications in respect of each of these. The risk assessment which has been carried out forms part of the background papers to the report.

FINANCIAL	The financial implications are outlined within the report.

LEGAL	Compliance with various Regulations and statutory Codes of Practice

RISK	The Council's treasury management strategy and policies are designed to ensure the effective control and management of the risks associated with such activities.

THE IMPACT ON EQUALITY	

OTHER (see below)	

Asset Management	*Corporate Plans and Policies*	*Crime and Disorder*	*Efficiency Savings/Value for Money*
Equality, Diversity and Community Cohesion	*Freedom of Information/ Data Protection*	*Health and Safety*	*Health Inequalities*
Human Rights Act 1998	*Implementing Electronic Government*	*Staffing, Training and Development*	*Sustainability*

BACKGROUND DOCUMENTS

Treasury Management in the Public Services: Code of Practice
DCLG Guidance on Local Government Investments
Background Papers – Review of Investment Counterparties 2015/16

1. DCLG Guidance on Local Government Investments
2. Capita Asset Services' Suggested Credit Policy
3. Banks incorporated in the UK
4. EEA non-UK banks accepting deposits in UK branches
5. Non-EEA banks accepting deposits in UK branches
6. Other non-UK banks monitored by Capita Asset Services
7. Building Societies incorporated in the UK