

REVIEW OF TREASURY MANAGEMENT

Report of the County Treasurer

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.
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Recommendations:

- (a) That the Pension Fund Treasury Management Strategy be amended as outlined in paragraphs 2.5 and 2.6 below.**
- (b) That Barclays Bank is put back onto the approved counterparty list, and that the Coventry Building Society and the Leeds Building society be added to the Counterparty List.**

1. Introduction

- 1.1. At their meeting on 14th October, Devon County Council's Cabinet agreed changes to the Council's Treasury Management Strategy. The Devon Pension Fund has for many years always adopted a treasury management strategy for the management of the Fund's cash that is consistent with the County Council's strategy. This report is therefore being brought to the Investment and Pension Fund Committee to update the Pension Fund's policy in line with that of the County Council.
- 1.2. The Council has for many years adopted a very cautious and prudent approach to treasury management. Lending has only been made to banks and building societies which have strong credit limits and meet the criteria set by the Council, using information published by the three major credit rating agencies. In the past this policy has enabled the Council to avoid having any exposure to the riskier areas of treasury management such as the Icelandic banks in 2008. This policy has been maintained in the knowledge that putting security before liquidity or yield does impact on the income being generated from these investments.
- 1.3. However, the nature of risks is changing, with banks no longer being seen as ultra-safe, and the new regulatory environment around the concept of 'bail-in' meaning that rating agencies are now placing less reliance on Governments to bail out failing banks. The impact of bail-in, and proposed changes to the Pension Fund's Treasury Management Strategy, are set out below.
- 1.4. The Council's Treasury Management Strategy was also amended to allow investment in the CCLA (Churches, Charities and Local Authorities) Property Fund. The Pension Fund is in a different position to the County Council in that it already has a wide variety of investments, including property funds being managed by Aviva Investors. Therefore it is not proposed that the Pension Fund should invest in the CCLA Property Fund as part of its Treasury Management Strategy.

2. The Impact of “Bail-in”

- 2.1 During the financial crisis of 2007/08 the Government stepped in to bail out the Royal Bank of Scotland and Lloyds Bank. The perception has been that the major banks would not be allowed to fail, and the likelihood of the Government stepping in to provide support was reflected in the credit ratings of the major UK banks. However, the new regulatory environment is putting more emphasis on the requirement for investors to take a hit by funding a “bail-in”. A bail-in is where the bank’s creditors, including local authorities depositing money with them, bear some of the burden by having part of the debt they are owed written off. New regulation also requires banks to hold a larger capital balance to ensure the security of deposits and to meet any significant cashflow event.
- 2.2 In recognition of the revised regulatory environment, the credit rating agencies are now adjusting their ratings to reflect the ability and likelihood of the Government providing financial support and are removing any previous uplift awarded for this support. At the same time, they are reviewing where banks have increased their capital ratios, and in many cases this will have a positive impact on their rating, which may offset the perceived loss of Government support. In early June Standard and Poors concluded a review of UK banks and as a result many banks, including Lloyds, had their ratings affirmed at the previous level.
- 2.3 However, as reported to the June meeting of Corporate Services and the July meeting of Cabinet, Barclays Plc, one of the County Council’s major counterparties for lending, suffered a ratings downgrade, and as a result their short term rating no longer satisfies the County Council’s current lending criteria. All the funds held by Barclays in an interest bearing call account were immediately withdrawn. The situation is difficult, as Barclays are the Council’s bankers, but cashflow management ensures that the sums held with Barclays overnight are maintained at a minimum level (less than £100,000). An analysis of Barclays current credit rating from the three major agencies against the Devon County Council criteria is shown at Appendix 1.
- 2.4 The key reason that Barclays have been affected by the review and suffered a worse result than other banks is that the entity being reviewed includes their investment bank, which is deemed to be a more risky enterprise. This is not true, for example, in relation to Lloyds. Discussions have been held with Barclays and with Capita, the Council’s treasury advisors. Capita use a range of other metrics to assess the creditworthiness of a counterparty, including the price of credit default swaps (CDS). A CDS is in effect the cost of insuring against a bank default, and the more likely the bank is to default, the higher the price of the CDS. Using their metrics Capita continue to include Barclays on their list of recommended counterparties.
- 2.5 It is therefore proposed that a change could be made to the Treasury Management Strategy which would allow Barclays back onto the list. The proposal is that the following criteria be added to the strategy:

“Where the short term rating of a counterparty is one notch below the stated criteria, but the counterparty meets the long term rating criteria, they may still be used subject to the advice of our external advisors (Capita) who will take into account a range of other metrics in arriving at their advice.”
- 2.6 A further result of recent reviews by the major ratings agencies is that Moodys have upgraded the ratings of the Leeds Building Society and the Coventry Building society. The building societies did not benefit in the same way from the perception

that they would be bailed out by the Government, but have increased their capital ratios. It is therefore proposed that these two building societies could be added to the Council's counterparty list. These two building societies are only rated by two of the three rating agencies. In the past this has not been a barrier to inclusion on the counterparty list, but it is proposed that the Treasury Management Strategy is clarified by the statement that:

"Where the counterparty is only rated by two of the major ratings agencies the lowest rating published by either of the two is used."

3. Conclusion

- 3.1 Despite the issues around "bail-in" and the downgrading of their credit rating, Barclays are not considered a significant risk, and it would therefore not be unreasonable to amend the Treasury Management Strategy to permit their reintroduction to the Council's counterparty list. It is also proposed to add the Coventry and Leeds Building Societies.

Mary Davis

Electoral Divisions: All

Local Government Act 1972

List of Background Papers - Nil

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Appendix 1

Credit Rating Analysis - showing DCC Criteria and Barclays Ratings

DCC Limits	Rating Description	Moody's		S&P		Fitch	
		Long Term	Short Term	Long Term	Short Term	Long Term	Short Term
Up to £50m	Prime	Aaa	P-1	AAA	A-1+	AAA	F1+
	High Grade	Aa1		AA+		AA+	
		Aa2		AA		AA	
		Aa3		AA-		AA-	
Up to £30m	Upper Medium Grade	A1	P-2	A+	A-1	A+	F1
		A2		A		A	
		A3	A-	A-	A-	F2	
Do not meet criteria	Lower Medium Grade	Baa1	P-3	BBB+	A-2	BBB+	F3
		Baa2		BBB		BBB	
		Baa3	BBB-	A-3		BBB-	
	Non-investment Grade Speculative	Ba1	Not Prime	BB+	B	BB+	B
		Ba2		BB		BB	
		Ba3		BB-		BB-	
	Highly Speculative	B1		B+		B+	
		B2		B		B	
B3		B-		B-			

Barclays Ratings