Stevenage BOROUGH COUNCIL

Part I – Release to Press

Meeting: **COUNCIL**

Portfolio Area: Resources

Agenda Item: **16**

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TREASURY MANAGEMENT STRATEGY - URGENCY DECISION ON SOVEREIGN RATING DOWNGRADE

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REASON FOR URGENCY

Consideration of this matter cannot wait until the next meeting of the Audit/Executive and then Council as further changes to the UK sovereign rating could mean a breach of the Treasury Management Strategy.

1. PURPOSE

1.1 To update Members on the implications of the EU Referendum decision on the UK sovereign rating and to seek approval from Members to change the Treasury Management Strategy by excluding the UK from the minimum sovereign rating should it fall below AA-.

2. RECOMMENDATIONS

2.1 That the exclusion of the UK from the Council's minimum sovereign rating criteria of AA- for approved countries for investment be approved.

2.2 That the use of UK financial institutions based on their individual UK entity ratings and not the UK sovereign rating be approved.

3. BACKGROUND

3.1.1 The Council's Treasury Management advisors Capita have published an update on credit implications following on from the European Union (EU) Referendum decision on 24th June 2016 to leave the EU. The update suggests that the Council reviews their Investment Strategy with regards to the sovereign downgrading of the UK and the consequential impact on investment limits.

3.1.2 The Council's Annual Investment Strategy states that "*The Council only invests in counterparties with a high credit quality in the UK or other countries meeting minimum AA- sovereign rating"*. Part of the evolution of financial market regulations has seen the link between sovereigns and their respective banks materially weakened and the credit rating agencies new methodology means that sovereign ratings are now of lesser importance in the assessment process. The Council continues to specify a minimum sovereign rating as the underlying domestic and where appropriate, international, economic and wider political and social background will still have an influence on the ratings of a financial institution. Specified and Non-Specified Investment criteria reflects Capita's suggested methodology to assess short and long term ratings for a counterparty.

3.1.3 The Council's current Treasury Management Strategy uses approved counterparties from UK or selected countries with a minimum sovereign credit rating of AA- from Fitch Ratings (or equivalent from other agencies if Fitch is unavailable). This forms part of the criteria used to produce the Council's Counterparty List.

3.1.4 This report proposes making an exception to the use of the minimum sovereign credit ratings in the case of UK financial institutions due to the strength of the UK banks. There has been no change made by any of the three major credit rating agencies in relation to UK entity ratings.

4. REASONS FOR RECOMMENDED COURSE OF ACTION AND OTHER OPTIONS

Investments

4.1 The Council's Treasury Management Strategy uses a minimum sovereign rating requirement of AA- or equivalent by all three of the main credit ratings agencies: Fitch, Moody's and Standard and Poor's. The sovereign ratings and long term outlook in terms of economic prospects of the UK, following the EU Referendum are shown in the table below:

Credit Rating Agency	Previous Sovereign Rating	Current Sovereign Rating	Previous Outlook	Current Outlook
Fitch	AA+	AA	Stable	Negative
Moody's	Aa1	Aa1 (Equivalent to AA+ from Fitch/S&P)	Stable	Negative
Standard & Poor's (S&P)	AAA	AA	Negative	Negative

4.1.2 The Council has cash balances of £59.81Million as at 11th July 2016. The following table shows that the Council has 41% of its investments with UK financial institutions.

Investment Counter Party	Investment £Million	% of Total Investments
UK Financial Institutions	24.59	41%
Local Authorities	8.75	15%
AAA Money Market Funds	15.00	25%
National Australia Bank	5.00	8%
Svenska Handelsbanken	6.47	11%
Total Investments	**59.81**	**100%**

4.1.3 Non-UK financial institutions currently make up only 19% of the Council's investment portfolio. Members should note that the counterparty limit for each institution is £8Million.

4.1.4 If the UK's rating falls below AA- (the threshold in the current Treasury Management Strategy), there will be a lack of counter party availability if the Council cannot use UK banks, as there are few non-UK financial institutions active in the market.

4.1.5 Along with UK financial institutions, the Council would not even be able to place funds with the Government's Debt Management Office facility (DMO) which is used as a 'safe haven', (the Treasury Management Strategy allows for unlimited deposits here). As well as a safe haven when cash balances are high the DMO is used so as not to breach counter party limits.

4.1.6 In essence the Council would be in breach of the Treasury Management Strategy if investment balances were above £39.75Million, assuming the facility to place with existing non-UK counter parties was as shown below.

Investment Counter Party	Investment £Million
National Australia Bank	8.0
Svenska Handelsbanken	8.0
Money Markets	**15.0**
Local Authorities	**8.75**
Total Counterparties approved	**39.75**

Bank Rating

4.2.1 Since the financial crisis of 2008 financial market regulations have evolved and the link between sovereigns and their respective banks materially weakened. Part of this was to break the "negative feedback loop" that has been evidenced in Europe, where concerns over banks have weighed on sovereigns, which exacerbates the negative sentiment towards the banks… and then the process starts all over again.

4.2.2 There is now little or no "sovereign uplift" to any major bank ratings in the UK and beyond. The implication is that the sovereign rating change of the UK does not mean that its financial institutions will necessarily be similarly affected.

4.2.3 If a banks economic performance is negative or poor this be reflected in its individual rating and these are updated in real time to the Council's Treasury Management team by the Council's advisors.

4.2.4 In addition UK banks are stronger in terms of capital and liquidity than before the financial crisis. Mark Carney, Governor of the Bank of England stated on Friday, in the immediate aftermath of the vote that "…the capital requirements of our largest banks are now ten times higher than before the crisis. The Bank of England has stress tested them against scenarios more severe than the country currently faces. As a result of these actions, UK banks have raised over £130bn of capital, and now have more than £600bn of high quality liquid assets."

4.2.5 The issue of the use of minimum sovereign rating of AA- will be reviewed for other countries banks as part of the next treasury review.

5. IMPLICATIONS

5.1 Financial Implications

5.1.1 This report is financial in nature and consequently financial implications are included in the above.

5.2 Legal Implications

5.2.1 None identified at this time.

5.3 Policy Implications

5.3.1 The policy implications are as outlined in the report above.

5.4 Equality and Diversity Implications

5.4.1 This report is of a technical nature and there are no EQIA implications identified.

5.5 Risk Implications

5.5.1 If the UK's sovereign rating is further downgraded the risk of not making the recommended change will be a breach of the current Treasury Management Strategy as outlined in paragraph 4.1.6.

5.5.2 The risk of the sovereign rating effecting individual UK entities is low in the short term however a sustained period of negative implications on the economy resulting from the EU withdrawal would inevitably impact on banks which focus most of their business in the UK.

5.5.3 As stated by the Governor of the Bank of England the capital requirements of our largest banks are ten times higher than before the financial crisis. The Bank of England has stress tested them against scenarios more severe than the country currently faces.

BACKGROUND DOCUMENTS
Treasury Advisors guidance

APPENDICES
None