Arlingclose Ltd:
Independent treasury management services

A pro-active approach to addressing regulatory change

CIPFA Scottish Treasury Management Forum

27th February 2014

Mark Horsfield and Mark Pickering

60 Moorgate London EC2R 6EL
Tel +44(0)8448 808 200
Fax +44(0)8448 808 205
www.arlingclose.com

Registered Office Barclays Bank Chambers Stratford-upon-Avon CV37 6AH
Registered in England No 2853836
Authorised and Regulated by the Financial Conduct Authority No 417722
Arlingclose Limited provides independent advice

Broad themes

Balance Sheet Forecasting

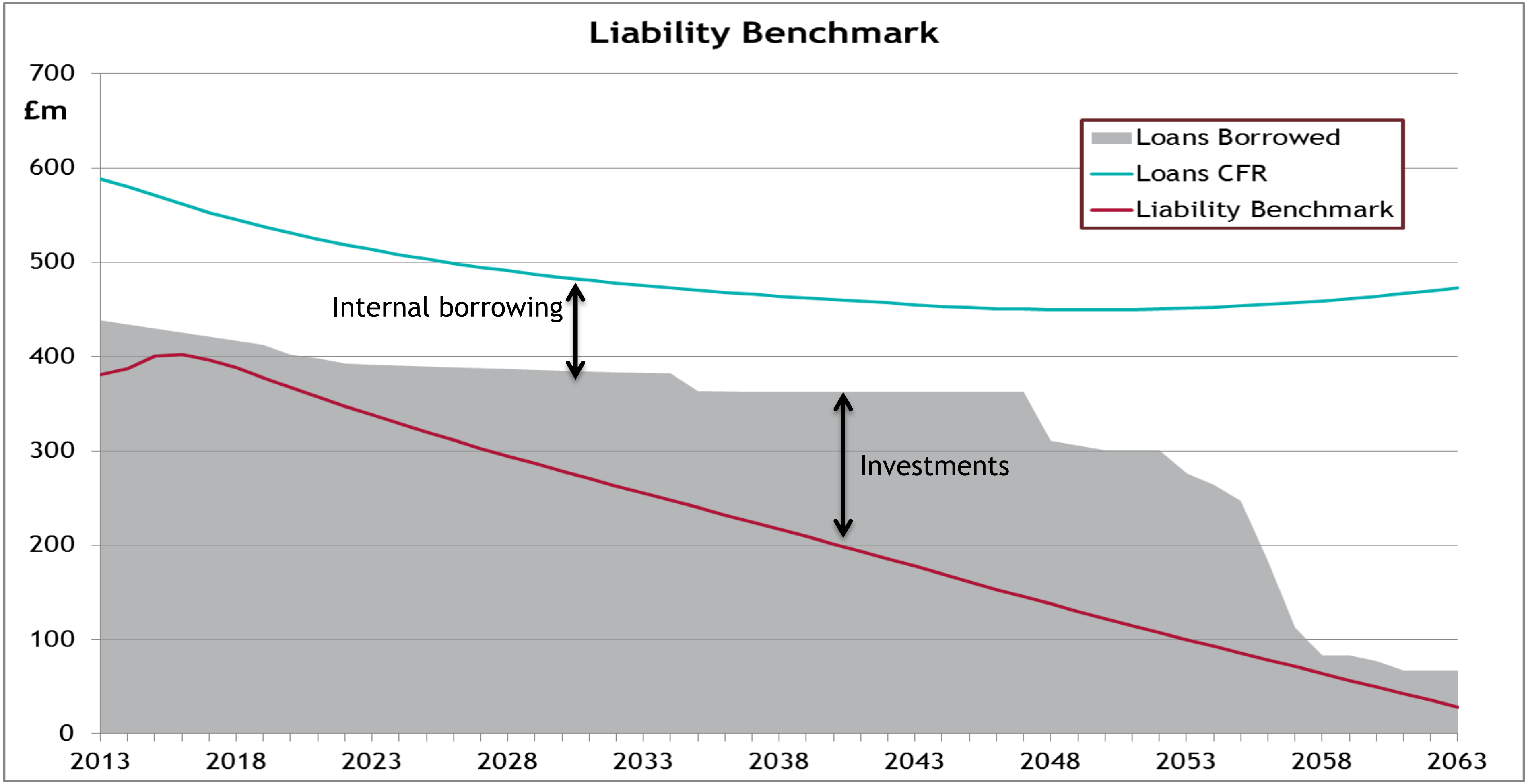
Example Authority					
Balance Sheet Summary and Projections in £millions					
31st March:	2013	2014	2015	2016	2017
Capital Financing Requirement	625.3	615.2	604.2	593.3	583.1
Less: Other Long-term Liabilities	-37.0	-34.8	-33.1	-31.5	-29.9
Loans CFR	**588.3**	**580.4**	**571.2**	**561.8**	**553.2**
Less: External Borrowing	-438.5	-434.2	-429.8	-425.5	-421.1
Internal (Over) Borrowing	**149.8**	**146.2**	**141.3**	**136.3**	**132.0**
Less: Usable Reserves	-225.0	-210.4	-187.5	-176.3	-173.4
Less: Working Capital	-7.4	-7.6	-7.8	-8.0	-8.2
Investments / (New Borrowing)	**82.6**	**71.7**	**53.9**	**47.9**	**49.6**
Net Borrowing Requirement	355.9	362.4	375.9	377.6	371.6
Minimum Liquidity	25.0	25.0	25.0	25.0	25.0
Liability Benchmark	**380.9**	**387.4**	**400.9**	**402.6**	**396.6**

Liability Benchmark

— Minimum amount of borrowing required to keep investments at minimum liquidity level (which may be zero)

— Can be estimated for the long term if a few assumptions are used

Liability Benchmark

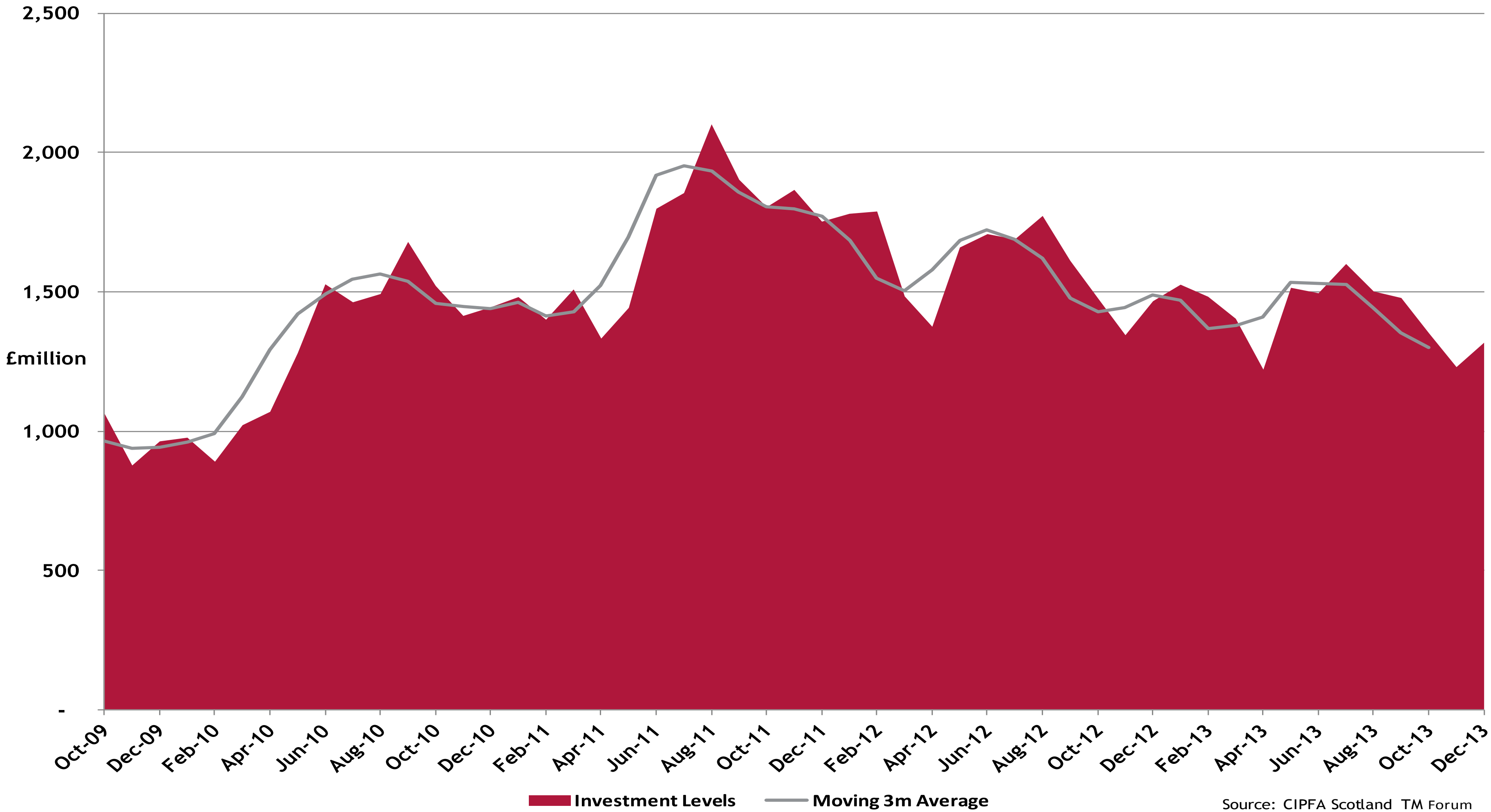


Borrowing activity is markedly lower

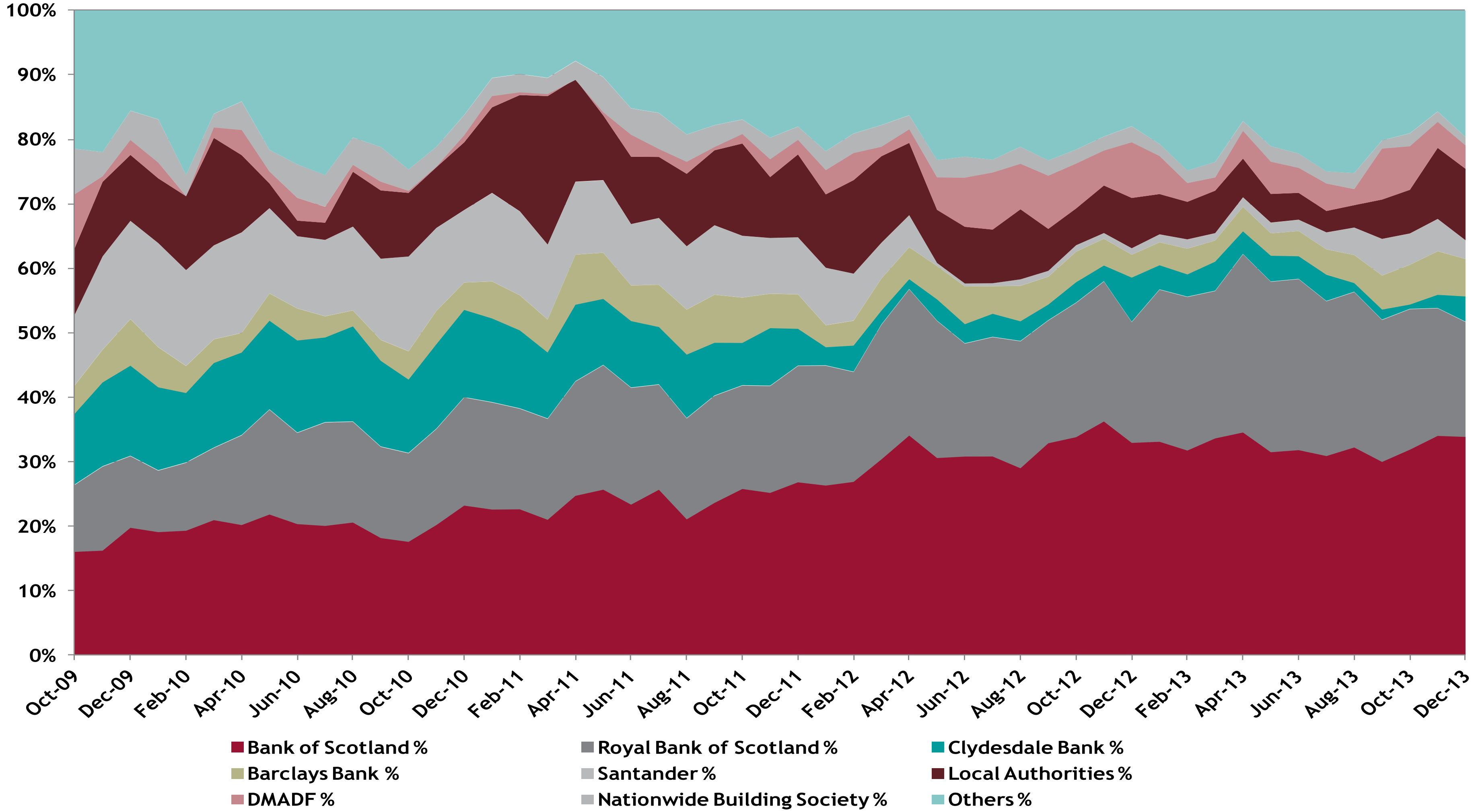
	Apr 12-Jan 13	Apr 13-Jan 14
PWLB borrowing	£2.31bn	£1.30bn
GLA borrowing	£1.10bn	£0.70bn
Borrowing ex-GLA	£1.21bn	£0.60bn
PWLB Borrowing by Scottish Authorities	£0.35bn	£0.23bn

Source: PWLB

Investment balances are reasonably resilient…

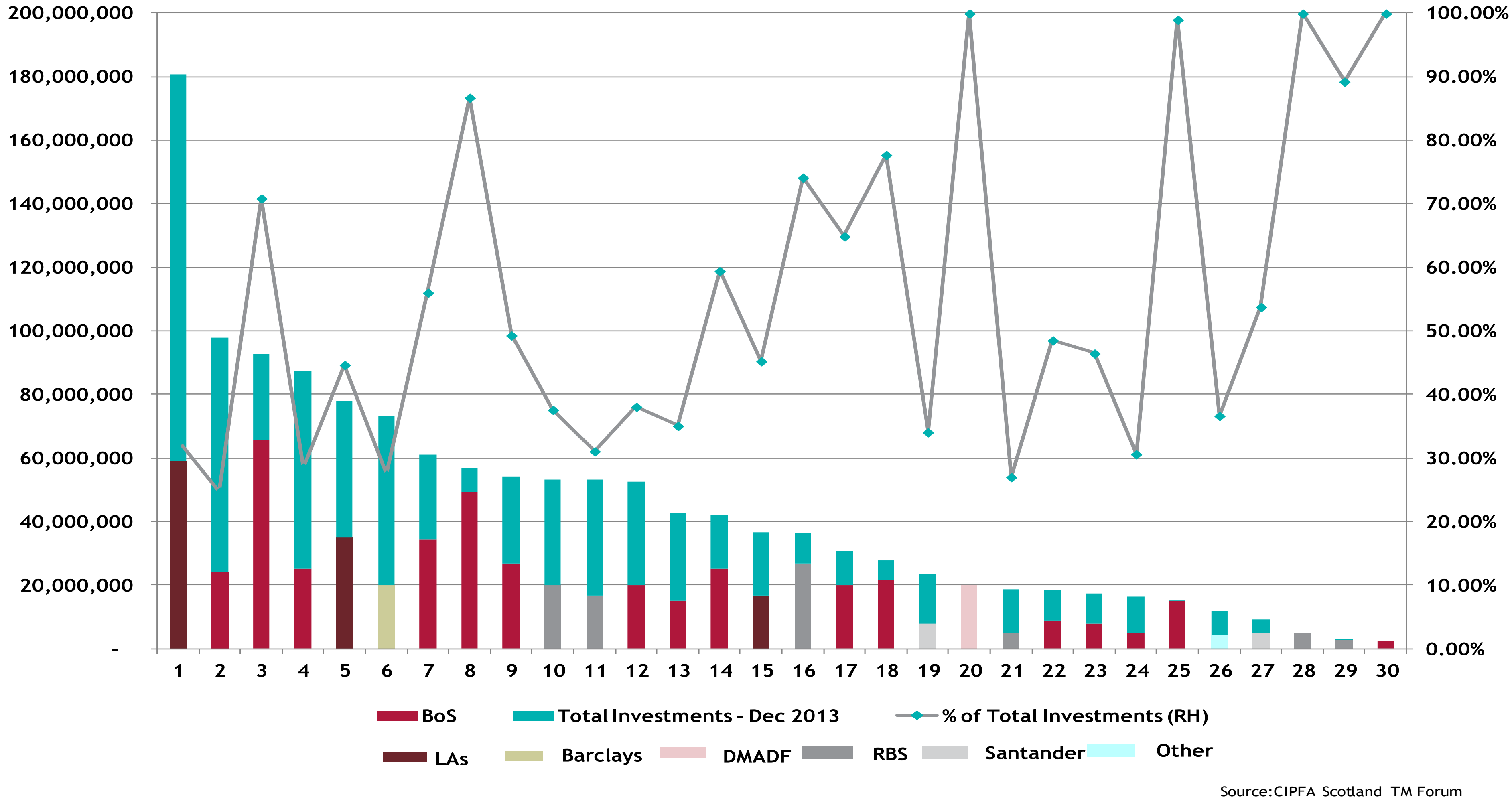


And concentrated ....



Source: CIPFA Scotland TM Forum

Really concentrated ....



*“The Times They Are A Changin” **

**In fact, they already have.*

Credit Risk Management

The main drivers of credit risk are

- The chance of the counterparty **failing** in the first place
- The chance of the counterparty receiving external **support** to prevent failure turning into **default**
- The size of the **loss** incurred given default

Countries around the world have vowed "never again" to bail out their banks

- UK - Independent Commission on Banking (2011) and the Financial Services (Banking Reform) Act 2013
- EU - Bank Recovery and Resolution Directive (2013 proposal)
- US - Dodd–Frank Wall Street Reform and Consumer Protection Act (2010)

Bail-in is the new bail-out

- Depositors and senior bondholders: Amagerbanken (Denmark, 2011, **41%**); Bank of Cyprus (2013, **47.5%**)
- Junior bondholders: Bank of Ireland (2011, **80%**); SNS Reaal (Netherlands, 2013, **100%**); Co-op Bank (~**50%**)

Minimising the chance of clients being exposed to a failing bank remains our main concern

But with the probability of external support reducing, we are focusing more on lowering loss given default

- Advising on investments with intrinsically low loss given default
- Increasing diversification so that any loss would be a smaller proportion of total investments

UK Banking Reform

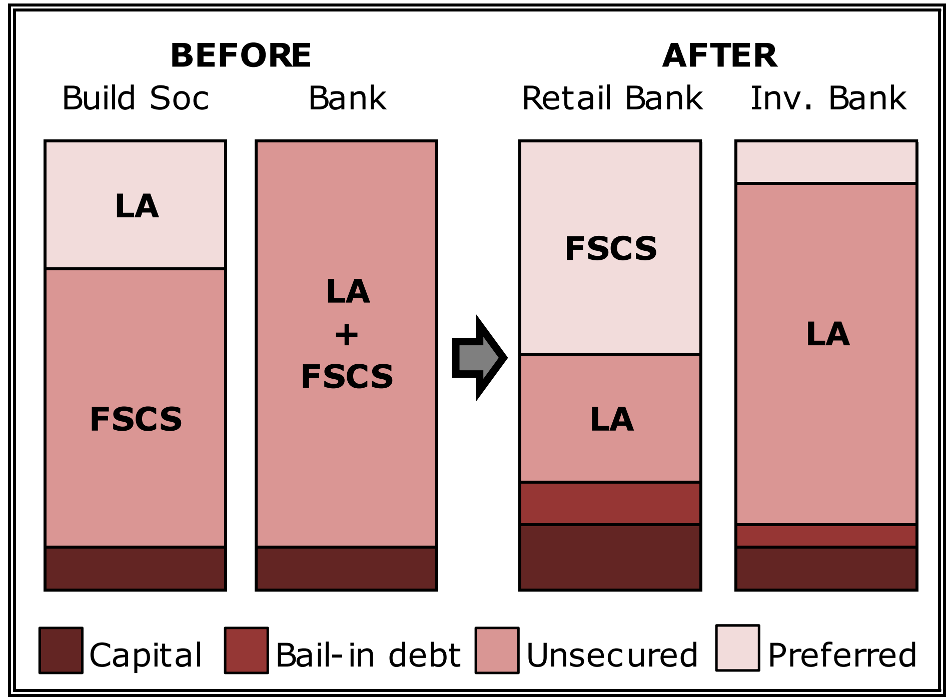
Independent Commission on Banking Report (2011) — Financial Services (Banking Reform) Act 2013

- Separation of retail and investment banking
- FSCS-insured depositor preference
- Higher capital requirements
- Bail-in power

LAs will have a choice where to bank & invest

- Retail banks
  - Higher capital and therefore “safer”
  - But more exposed to bail-in
- Investment banks
  - Likely to pay higher rates
  - Lower loss given default?

Full implementation planned by 2018



EU Banking Reform and Bail-in

Bank Recovery and Resolution Directive (2013 proposal)

- National regulators will be required to **bail-in** creditors in order of seniority until their losses reach at least **8%** of the bank's liabilities before any government money can be injected
- Many liabilities are exempt from bail-in:
  - insured retail and small business deposits
  - interbank lending with a maturity of less than one week
  - secured debt such as covered bonds
- This would leave local authority and other large deposits as one of the few categories able to take losses
  - e.g. if unsecured bonds and wholesale deposits make up just 20% of the balance sheet, they will need to take a haircut of **40%** to write down 8% of total liabilities
- Governments can then contribute up to **5%** of the failing bank's liabilities
- If further funds are required, these must come from deeper haircuts on unsecured creditors
  - it would be illegal for any more government money to be injected until bondholders and wholesale depositors were completely wiped out

Likely date for EU-wide implementation is January 2016

UK has adopted these proposals early and they are now law

European Commission

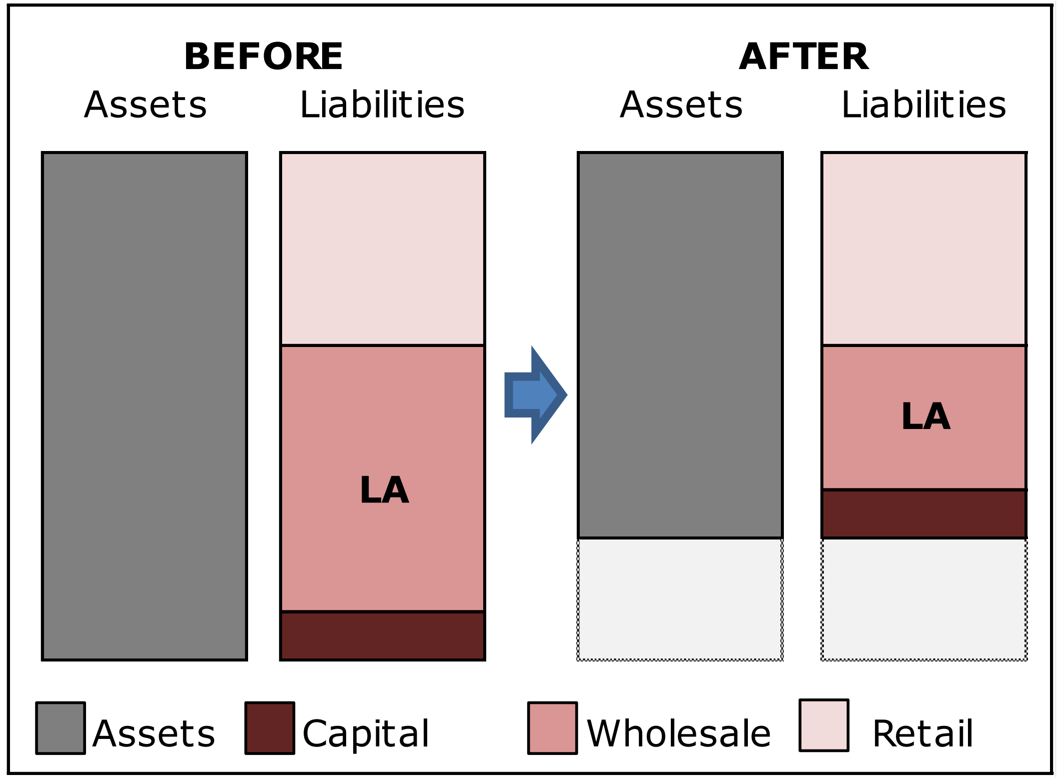
Bail-in Example

Amagerbanken was a small Danish bank that failed in February 2011

– Suffered large losses on its £3.5bn loan portfolio

Simple bail-in process

– Bank closed on Friday afternoon
– Over the weekend, 41% was removed from all accounts with balances over €100,000
– 41% calculated as the amount required to cover losses and leave adequate capital buffer behind to continue trading
– Bank re-opened Monday morning
– Retail customers hardly noticed the change

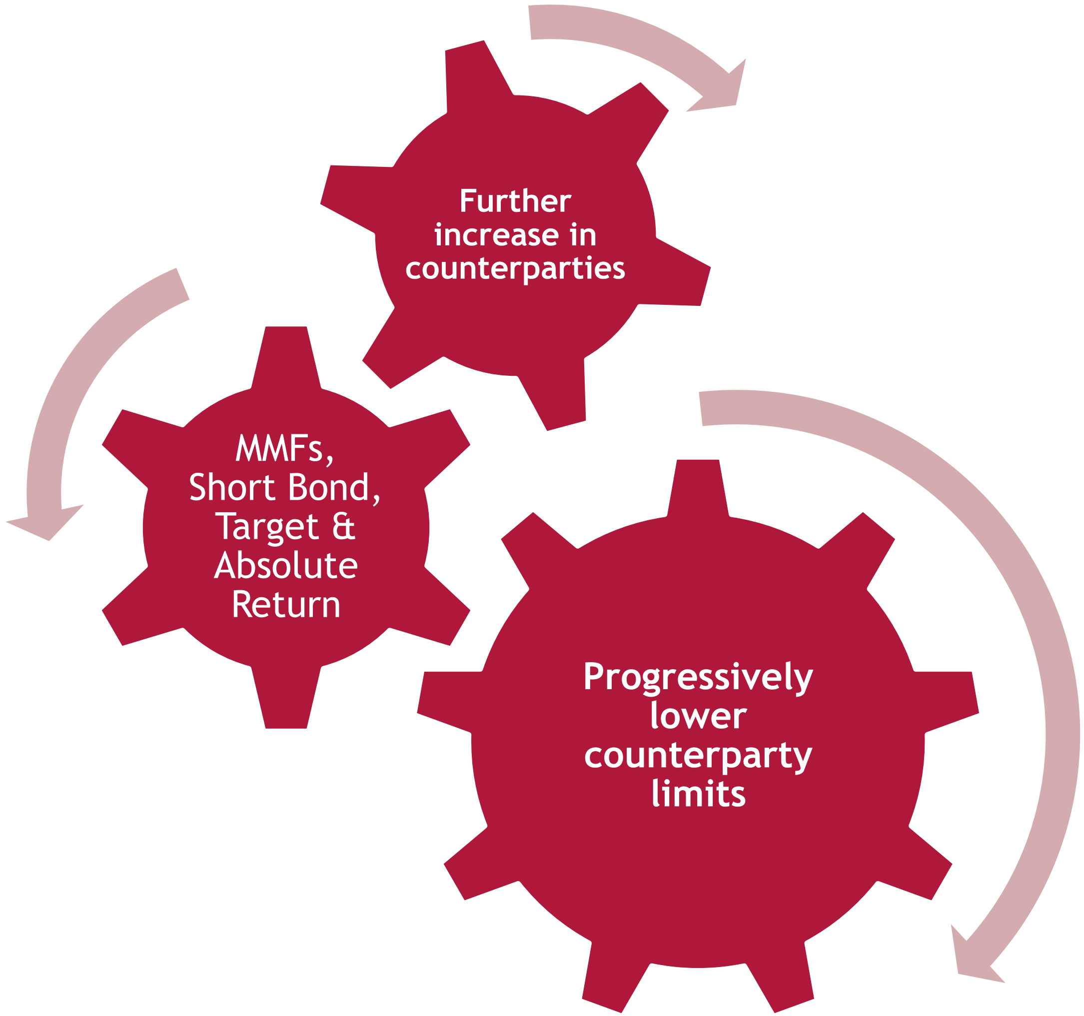


Similar story at Fjordbank Mors in July 2011

– Bail-in of 26% on uninsured depositors

A pro-active response is preferable

Diversification



Low Credit Risk Investments

Low Probability of Default

Government Investments

- Debt Management Account Deposit Facility
- Treasury Bills
- Gilts

Government Related Investments

- Government Agency Bonds
  - e.g. Network Rail
- Supranational Bank Bonds
  - EIB, NIB, EBRD, CEDB, IBRD
- Loans to Local Authorities

Government Investment Funds

- Gilt Funds

Low Loss Given Default

Secured Investments

- Covered Bonds
- Reverse Repurchase Agreements (Repo)
- Loans to Housing Associations

Property Investments

- Investment Property
- Local Housing
- Property Funds

Diversified Investments

- Money Market Funds
- Bond Funds

Local Authority Loans: Security

Local Authorities are a low credit risk investment, even over the long-term

– Central Government funding & control
– Therefore linked to UK sovereign credit rating
– Balanced budget requirement
– Pledging security prohibited
– High reserves and low debt
– Strong liquidity from PWLB
– CIPFA Prudential Code & TM Code

	Fitch	Moody's	S&P
Kensington & Chelsea			AAA
Cornwall		Aa1	
Birmingham		~~Aa1~~	
Greater London Authority			AA+
Guildford		Aa1	
Wandsworth	AA+	Aa1	
Lancashire		Aa2	
Transport for London	AA	Aa2	AA+
Woking			A+

Summary

As government support for banks is withdrawn, and bail-in risk increases, there are three broad options for reducing credit risk

Diversification:
- Internal - use a wider range of counterparties for smaller amounts
- External – money market funds and other pooled funds

Investments with a low chance of default:
- Treasury bills
- Gilts
- EIB bonds
- Local authority loans

Investments with a low loss given default:
- Housing associations
- Covered bonds
- Property based

Appendices

Don’t just take our word for it....

“But look, we are having an independent inquiry into what went on in the Co-op and I would just make this point, which is the first priority is to save this incredibly important bank.

It has 600,000 customers, many thousands of people work for the Co-op and will be anxious about their jobs, and a huge amount of my time and the time of the Treasury is spent on making sure this bank survives and survives in a way that does *not depend on a taxpayer bailout, which we want to move away from in this country*.”

George Osborne interview on BBC Radio 4 Today programme, 25th November 2013

Bail-in powers enacted in Financial Services (Banking Reform) Act 2013 just a few weeks later.

Disclaimer

This document is issued by Arlingclose Limited (Authorised and Regulated by the Financial Conduct Authority) for information purposes only and does not constitute an offer by any Arlingclose company to enter into any contract/agreement nor a solicitation to buy or sell any investment or to provide any services referred to therein. Arlingclose Limited provides independent advice.

The contents of this document are based upon sources of information believed to be reliable, however, save to the extent required by applicable law or regulations, no guarantee, warranty or representation (express or implied) is given as to its accuracy or completeness and, Arlingclose Limited, its directors, officers and employees do not accept any liability or responsibility in respect of the information or any recommendations expressed herein which, moreover, are subject to change without notice. Nothing in this document should be deemed to constitute the provision of financial, investment or other professional advice in any way. This document may include forward-looking statements that are based upon our current opinions, expectations and projections. We undertake no obligation to update or revise any forward-looking statements. Actual results could differ materially from those anticipated in the forward-looking statements.

All data has been sourced from Bloomberg and other publicly available information.

Further details regarding Arlingclose services can be obtained from:

Arlingclose Limited

60 Moorgate

LONDON EC2R 6EL

Tel: 08448 808200

Email: info@arlingclose.com

Web: www.arlingclose.com