

Treasury Management and Investment Strategy 2023/24 – Credit Risk Update

Report by David Gladwin, Acting Chief Financial Officer

Report for Noting

1 Recommendations

The Audit Committee is invited to note the content of this report.

2 Purpose of Report/Executive Summary

This paper has been prepared to provide an update to Audit Committee members on the current market position regarding credit risk on deposits, the Council's exposure to credit risk, and how this risk is mitigated through the Council's assessment of counterparty creditworthiness in the approved TMIS.

Date: 10 April 2023

Report Contact:

Gary Thomson, Senior Finance Business Partner

gary.thomson@midlothian.gov.uk

0131 271 3230

3. **Background**

At the Council meeting on 21 March 2023, elected members requested that a paper be brought to the next meeting of Audit Committee to update members on the current market position regarding credit risk.

4. **Silicon Valley Bank / Credit Suisse / UBS**

On 10 March 2023, Silicon Valley Bank, a bank domiciled in the US, collapsed. The bank was the 16th largest bank in the United States and heavily involved in lending to the venture capital-funded technology and life sciences sector in the United States. The bank was vulnerable as a result of having a high proportion of uninsured deposits and a large proportion of deposits invested in hold-to-maturity securities. This was followed by the failure of Signature Bank, a New-York based bank that was heavily involved within the crypto-currency industry.

Subsequent to this, on 19 March 2023, Credit Suisse, a bank domiciled in Switzerland which had been under-performing relative to its peers for some time, also collapsed. Credit Suisse was the 2nd largest bank in Switzerland and was acquired by UBS AG in an acquisition supported by the Swiss authorities and regulators. UBS plans to sell off and downsize parts of Credit Suisse, although details remain scarce.

Following the acquisition, credit rating agencies have downgraded UBS AG as follows:-

UBS AG:-

- Standard & Poor's - affirmed the bank's ratings as A-1 short term and A+ long term.
- Moody's - affirmed the bank's ratings as P-1 short term and Aa2 long term but lowered the Outlook to Negative.
- Fitch - placed the bank's Long and Short Term ratings on Negative Watch, and noted that due to the complexity and size of the proposed merger, these may stay in place for upwards of six months (outside of mergers, Watches typically get resolved within weeks).

The long-term implications for UBS continue to be tricky to determine, as the merger will be a complex process (as noted by Fitch) that could weigh on the overall strength of the combined organisation. However, these "unknowns", will most likely be supported by Swiss authorities, including loan loss provisions and a substantial liquidity facility that has already been put in place, if required.

Outside of affected entities (Swiss and regional US banks), there have been no credit rating changes within the banking sector resultant from this market disruption to date.

5. **Approved TMIS 2023/24 – Credit Risk to Midlothian Council**

The Council's approved TMIS requires that the Council follow the security, liquidity, yield principle, in line with the Prudential and Treasury Management Codes, when making all deposit considerations.

This is assessed as follows:-

1. The Council's approved TMIS states that, when assessing a counterparty credit strength (security), it will only use approved counterparties from the UK, or approved counterparties from other countries, where the counterparty is domiciled in a country that has a minimum sovereign credit rating of AA- from Fitch. The list of countries that currently qualify and are rated AA- or above is outlined in Appendix 1. This list is added to, or deducted from, by officers, should rating change.
2. The second layer is to consider the credit strength of the individual counterparty, and to do so the Council uses the creditworthiness service from its Treasury advisers, Link.

This second layer employs a sophisticated modelling approach utilising credit ratings from the three main credit rating agencies - Fitch, Moody's and Standard and Poor's – to assess the creditworthiness of an individual counterparty. The credit ratings of counterparties are supplemented with the following overlays:-

- sovereign ratings to select counterparties from only the most creditworthy countries (see 1 above).
- credit watches and credit outlooks from credit rating agencies;
- Credit Default Swap (CDS) spreads to give early warning of likely changes in credit ratings;

The output of this analysis is to provide a colour banding for each counterparty which determines **the maximum duration for deposit**. This is outlined in Appendix 2 and ranges from No Colour (counterparty is Not to be Used) to Yellow (6 years maximum duration).

The Council then considers, from the list of qualifying counterparties using the above criteria, the optimum blend of liquidity and yield.

6. Assessment of banks domiciled in Switzerland

It is important therefore to note that whilst Switzerland's sovereign (country) rating is triple AAA from all 3 credit rating agencies, the individual counterparty ratings for banks domiciled within Switzerland are rated on their own merit, in line with the methodology outlined above in Section 5.

Under this methodology, Credit Suisse have not met the credit criteria to be a counterparty for investment consideration since 20th June 2022 (they are rated as "No Colour" by Link). This is a result of Credit Suisse's CDS market status having been "out of range" since this date. This indicates that the creditworthiness service employed by Link, as outlined above, is acting effectively.

UBS AG have been rated as Orange (12 months) by Link since the upgrade of its S&P Long-Term rating in June 2016, prior to the events of last month. Following the acquisition of Credit Suisse, the CDS price for UBS AG rose to a peak of 150bps (to sit in the Link monitoring range), which has adjusted the Link suggested colour banding down from Orange (12 months) to Red (6 months). The CDS price at the time of writing has now dropped back to sit at 115bps, just above the Link 'in-range' zone.

7. Midlothian Council – current deposits

All deposits placed by the Council have, and will continue to be, placed with high creditworthy counterparties in accordance with the approved creditworthiness policy as outlined in Appendix 2.

The deposits reflect a mix of those placed to manage day to day liquidity needs (i.e. deposits with Money Market Funds and Bank Call Accounts) and those placed for a longer duration, which either cash back the Council's useable reserves (and with a tenor reflective of the expected drawdown of useable reserve forecasts, and at a yield commensurate with this duration), and those that are surplus cashflow generated as a result of grant receipts paid in advance.

The Council's current list of deposits at 31 March 2023 totals £113.982 million and is as follows:-

Counterparty	Amount £000's	Security Long/Short Term Rating* (Colour)**	Liquidity	Yield	UK Local Authority Investment £000's
MMF Aberdeen	2,342	AAAmf (Yellow)	Instant Access	3.93%	1,931,129
MMF Federated	14	AAAmf (Yellow)	Instant Access	3.92%	1,008,282
MMF LGIM	13,624	AAAmf (Yellow)	Instant Access	3.96%	306,784
Handelsbanken AB Call Account	2	AA/F1+ (Orange)	Instant Access	3.80%	721,491
Lloyds Bank Corporate Markets plc	30,000	A+/F1 (Red)	Start: 30 Nov 2022 End: 30 May 2023	4.25%	272,800
National Westminster Bank plc	15,000	A+/F1 (Blue)	Start: 31 May 2022 End: 31 May 2023	2.00%	1,052,317
National Westminster Bank plc	15,000	A+/F1 (Blue)	Start: 08 Mar 2023 End: 08 Mar 2024	4.80%	1,052,317
Toronto Dominion Bank	10,000	AA-F1+ (Orange)	Start: 16 Jun 2022 End: 15 Jun 2023	2.85%	436,311
Landesbank Hessen- Thuringen Girozentrale	5,000	A+/F1+ (Orange)	Start: 30 Nov 2022 End: 29 Nov 2023	4.47%	306,000
Standard Chartered Bank	10,000	A+/F1 (Red)	Start: 30 Nov 2022 End: 30 May 2023	4.06%	944,807
SMBC Bank International	11,000	A-/F1 (Red)	Start: 02 Feb 2023 End: 02 Jun 2023	4.13%	200,500
Stoke on Trent City Council	2,000	Quasi-UK Government (AA- / Yellow)	Start: 06 Apr 2020 End: 06 Apr 2023	1.60%	3,029,079
Total	113,982				11,261,817

As can be noted from the table above, the Council has no direct exposure to any counterparty domiciled in Switzerland.

The Council have a diversified portfolio which is spread across the UK, Canada and Germany. Canada has the highest possible sovereign rating ("AAA") from both Moody's and Standard & Poor's and a "AA+" rating from Fitch, one notch below the highest possible. Its major banks, including Toronto Dominion are all designated "Orange – 12 months" under the Link methodology. Likewise, Germany has the highest possible sovereign rating from all three rating agencies, while Landesbank Hessen-Thuringen Girozentrale is also designated "Orange – 12 months" under the Link methodology.

APPENDIX 1: Approved countries for investments

Based on the lowest available rating as at 07.04.2023

AAA

- Australia
- Denmark
- Germany
- Netherlands
- Norway
- Singapore
- Sweden
- Switzerland

AA+

- Canada
- Finland
- U.S.A.

AA

- Abu Dhabi (UAE)
- France

AA-

- Belgium
- U.K.

Appendix 2: Permitted Investments

The Council uses the Link creditworthiness service for specific categories of permitted investments. This utilises credit ratings from the three main credit rating agencies – Fitch, Moody's and Standard & Poors, along with credit watches, outlooks, CDS spreads and country sovereign ratings in a weighted scoring system with an end product of a series of colour coded bands which indicate the relative creditworthiness of specific categories of counterparties for investment.

These colour codes are used by the Council to determine the maximum suggested duration for investment with that counterparty. These are as follows:-

Link Asset Services Colour Code	Maximum Suggested Duration for Investment
Yellow	6 years*
Dark Pink	6 years**
Light Pink	6 years**
Purple	2.5 years
Blue	1.25 years***
Orange	1.25 years
Red	7 months
Green	120 days
No colour	Not to be used

- * *Note the yellow colour category is for:- UK Government Debt, or its equivalent, Money Market Funds (MMF's), and collateralised deposits where the collateral is UK Government Debt*
- ** *Dark Pink for Ultra Short Dated Bond Funds with a credit score of 1.25; Light Pink for Ultra Short Dated Bond Funds with a credit score of 1.5*
- *** *Only applies to nationalised or semi-nationalised UK banks*

Note that the maximum suggested durations listed above have been extended by 1 year (when compared to the suggested maximum durations provided by Link) for the Yellow, Dark Pink, Light Pink categories (and so to 6 years); the Purple category by 6 months to 2.5 years; the Blue and Orange categories by 3 months to 1.25 years; the Red category by a month to 7 months, and the Green category by 20 days to 120 days. This is to allow flexibility around these durations on the margins e.g. the placement of a 13 month fixed term deposit for a counterparty rated Orange or Blue. A thorough appraisal of the additional risk involved in extending the duration of any deposit (marginally) beyond the maximum suggested by Link, against any enhanced value to the portfolio, will be undertaken prior to the placement of any deposit.