The Highland Council

Resources Committee - 27 August 2014

Agenda Item	**11.ii**
Report No	**RES/ 38/14**

Treasury Management and the Financial Services (Banking Reform) Act 2013

Report by Director of Finance

Summary

Following discussion at the Highland Council on 13 March 2014, in connection with the Council's Treasury Management Strategy Statement, this report sets out background to, and implications arising from, the Financial Services (Banking Reform) Act 2013.

1. Background

1.1 The Council's 2014/15 Treasury Management Strategy Statement and Investment Statement was approved by the Highland Council on 13 March 2014.

1.2 In discussion of that report, questions had arisen from members in relation to the implications arising from the Financial Services (Banking Reform) Act 2013, and it was agreed that a report on this matter would come to a future meeting of the Resources Committee. This report addresses these points.

2. The Act

2.1 The Financial Services (Banking Reform) Act 2013 became law in December 2013. The UK Government policy context for the Act was as described below:

"We have introduced the biggest reforms to the banking sector in a generation: to make banks more resilient to shocks, easier to fix when they get into difficulties, and to reduce the severity of future financial crises. We want to make sure that when banks make losses, retail customers aren't excessively affected and taxpayers' money isn't used to bail banks out."

2.2 The Act contains a number of provisions, summarised below:

- Separation of retail and investment banking, with ring-fencing of deposits for people and small businesses.
- Giving depositors, protected under the Financial Services Compensation Scheme, preference if a bank enters insolvency.
- 'Bail in' powers as described within this report.
- Giving Powers to the Prudential Regulation Authority to hold banks to account.
- Imposing higher standards of conduct on the banking industry and introducing a criminal offence for those causing a financial institution to fail.
- Introducing a cap on payday loans.

2.3 The main focus of this report, in terms of implications for the Council, is around the 'bail in' and deposit protection arrangements.

2.4 At the time of the economic crisis in 2008, the approach taken by the UK Government, and many other International Governments, was to ‘bail out‘ failing banks and financial institutions, on the basis they were ‘too big to fail’. Ultimately the costs of the ‘bail out’ fell on the taxpayer.

2.5 ‘Bail in’ (rather than ‘bail out’) is an approach where rather than Government intervention, instead a bank’s shareholders, creditors and investors are expected to be the first port of call in terms of suffering the financial implications of actions necessary to address an institution’s financial viability.

2.6 Examples of recent ‘bail ins’ include:

- In 2013 the Bank of Cyprus ‘bail in’ resulted in 47.5% of depositors funds (above a compensation limit) being used to ‘bail in’ the bank. With depositors giving equity in the bank in return for the reduction in their cash deposits.

- The recent Co-op bank situation, where bondholders agreed an initial ‘bail in’ of around 50%, resulting in bonds being exchanged for a mixture of new bonds and shares.

2.7 The move towards a ‘bail in’ approach is reflective of an international policy shift, with the European Union taking forward proposals for a ‘bail in’ approach being enshrined in EU law, and it is expected that this would apply effective from 1 January 2016.

2.8 While the application of EU legislation is expected from 2016, HM Treasury have stated that they do not intend to wait until 2016 for the application of EU Directives, meaning that ‘bail in’ is expected to be effective from January 2015 in the UK.

3. Implications for the Council

3.1 The Council is a significant depositor with banks and other financial institutions (with up to £100m cash on deposit at any one time). The Council is also deemed an ‘institutional investor’ in regulatory terms, which removes some of the protections offered to other retail bank depositors. As a result, the impact of any changes to the regulatory environment applying to banks will be of interest to the Council.

3.2 However, risks to the Council only materialise in the event of ‘bail in’ powers being used, and the Council using an institution which fails, or is at risk of failure.

3.3 The first and most effective mitigation the Council has against this risk, is to avoid a scenario where any funds are placed with an institution which is at risk of failure.

3.4 The Council already adopts a very low risk approach in its Treasury Management and Investment Strategy, with a primary focus on security of cash and using only counter-parties with high credit-worthiness. This low risk approach has been in place for a number of years and has avoided exposure to some of the financial implications faced by other organisations e.g. the collapse of Icelandic Banks.

3.5 In summary, key aspects of the Council's current strategy, focusing on security, are as follows:

- Using a diversified number of counter-parties to deposit its cash, and placing limits on the maximum exposure to each counter-party to mitigate and spread risk.
- Only using counter-parties of high credit worthiness, having assessed these based on credit ratings and advice from treasury advisors.
- Limiting the duration of any deposit with counter-parties, based on the credit worthiness assessment, to further manage and mitigate risk.
- Taking appropriate professional advice from its treasury advisors, and ensuring they take a pro-active role in raising with the Council any change in operational practice or treasury strategy that may be required due to a change in market conditions or the status of a counter-party.

The full Treasury and Investment Strategy is available from the following link: http://www.highland.gov.uk/NR/rdonlyres/3EC27EB5-3F50-4718-8EE8-5D0C1F8E46DC/0/Item15HC6613.pdf

3.6 The Council's current strategy therefore adequately addresses the risks associated with investing or depositing cash with financial institutions. **There is no need at this time to amend the Council's treasury strategy in light of the 'bail in' powers, given the low risk approach already taken.**

3.7 The only area which may be amended in a future revision to the Council's strategy, will be the duration and limit placed on deposits with individual institutions, and in particular the banks which the UK Government continues to hold significant stakes in.

3.8 At present the Council's strategy sets a higher cash limit for both RBS and Lloyds/BoS, based on their credit-worthiness and the extra weight given to support provided through the UK Government stake in and backing of these banks.

3.9 With the forthcoming implementation of 'bail in' powers in the UK in 2015, UK Government already reducing its stake in Lloyds/BoS, and expectations of a similar approach being taken to RBS over the medium-term, in time the Council may reach the view that these institutions no longer merit the higher cash limit derived from current Government support, and the duration of deposits placed may reduce also.

3.10 At this time, the Council's Treasury Advisors who provide credit worthiness information and assessment, remain comfortable that the level of UK Government ownership and backing still justifies a higher level of credit worthiness and duration for the two Government backed banks than their implicit credit rating alone. As stated earlier, through application of the Council's strategy, the credit worthiness of counter-parties is kept under regular review, as is the Council's policy.

4. Implications

4.1 Resource; Legal; Equalities; Climate Change/Carbon Clever; Risk, Gaelic and Rural implications – no specific implications to highlight, other than those set out within the report.

Recommendation

Members are asked to note this report.

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Background Papers:	None