Appendix 3 Credit Risk Policy

a) Counterparty Criteria

The Council considers, in order of priority, security, liquidity and yield when making investment decisions. Credit ratings remain an important element of assessing credit risk, but they are not a sole feature in the Council's assessment of counterparty credit risk.

The Council also considers alternative assessments of credit strength, and information on corporate developments of and market sentiment towards counterparties. In accordance with the 2011 Treasury Management Code of Practice, the Council will use the following key tools to assess credit risk:

- Published credit ratings of the financial institution and its sovereign rating;
- Sovereign support mechanisms;
- Credit default swaps (where quoted);
- Share prices (where available);
- Economic fundamentals, such as a country's net debt as a percentage of its GDP;
- Corporate developments, news, articles, markets sentiment and momentum;
- Subjective overlay.

The only indicators with prescriptive values remain to be credit ratings. Other indicators of creditworthiness are considered in relative rather than absolute terms.

The Council uses two Treasury Management Advisers to provide a counterparty risk management service- Arlingclose and Sector. Credit rating lists are provided by the Advisers based on the Council's minimum credit rating criteria as set out below. Both Arlingclose and sector have a different approach to counterparty risk management.

The Council will engage with its Advisers to maintain a monitor on market pricing such as credit default swaps, equity prices, economic data and overlay data to monitor credit ratings in order to generate a list of highly creditworthy counterparties. The intention of the strategy is to provide security of investment and minimisation of risk which will also enable diversification and thus avoidance of concentration risk.

The minimum credit ratings criteria the Council will use are:

	Fitch (or equivalent)- as per 2012/13 Strategy	**Fitch (or equivalent)- Proposed 2013/14**
Short-term	F1/F1+	F1
Long-term	AA-	A-
Support	-	1
Viability / Individual	-	a
Non-UK Sovereign	AAA	AAA
MMFs	AAA	AAA

The ratings set out above relate to Fitch, but Moody's and Standard's & Poor (S&P) have equivalent ratings. The following monetary and time limits will apply:

Counterparty	As per 2012/13 Strategy		Revised Limits 2013/14	
	Money Limit per Counterparty/ Banking Group	Maximum Duration	Money Limit per Counterparty/ Banking Group	Maximum Duration
DMADF	Unlimited	3 Months	Unlimited	3 Months
UK Government Bonds - T Bills	Unlimited	3 Months	Unlimited	12 Months
UK Government Bonds - Gilts	Unlimited	3 Months	Unlimited	2-Years
Part Nationalised Banks (UK)	-	-	£5m	3 Months
Banks & Building Societies	£5m	3 Months	£5m	3 Months
MMFs	£5m	On Call	£5m	On Call
Local Authorities (inclu Police & Fire)	£5m	3 Months	£5m	3 Months
Non-Specified Investments (as per Appendix 4)	£5m	2-Years	£5m	2-Years
Council's Banker	Unlimited	Per Operational/ Business Continuity Requirements	Unlimited	Per Operational/ Business Continuity Requirements

b) Comparison of Counterparty Lists

Arlingclose:

It is the practice of Arlingclose to provide a counterparty list consisting of UK and non-UK institutions with whom, they feel, the Council can make deposits with a degree of confidence. This list was explained to Members at the seminar presented by Arlingclose on 13/01/2011.

The most up-to-date Counterparty list (31/01/2013) lists the following qualifying institutions that are rated at least "AA" category across the three main rating agencies, and in accordance with the Council's minimum lending criteria as set out in the 2012/13 Strategy:

UK	Non-UK	Country
HSBC	Australia and NZ Banking Group	Australia
DMO	Commonwealth Bank of Australia	Australia
Local Authorities	National Australia Bank	Australia
	Westpac Banking Group	Australia
	Bank of Nova Scotia	Canada
	Royal Bank of Canada	Canada
	Toronto-Dominion Bank	Canada
Supernationals & Multinational Banks		
	Nordic Investment Bank	Finland
European Bank for Reconstruction	Council of European Development	France
	Kreditanstalt Fuer Wieferauf	Germany
	European Investment Bank	Luxembourg
	Inter-American development Bank	US
	International Bank for Reconstruction & Development	US

Arlingclose's creditworthiness methodology consists of reviewing a range of credit indicators when assessing current and potential counterparties. Indicators include a minimum long-term credit rating of A- (or equivalent), GDP data, CDS levels, share prices, economic fundamentals and corporate developments.

It should be noted that many UK, European and International banks\ building societies have been suspended from the UK and Non-UK Counterparty list due to the continuing Eurozone crisis and the ongoing problems in the banking sector. The institutions listed in the above table currently meet the Council's 2012/13 minimum lending criteria. Credit ratings are provided from all three main credit rating agencies.

Sector Treasury Services

Sector continues to provide information in the form of a creditworthiness matrix with which some Members are familiar from previous years, as well as one based on the minimum credit ratings criteria. The ratings are provided from all three main credit ratings agencies.

The matrix counterparty list gives an initial suggested lending period. This is subsequently adjusted to take into account any rating outlook/watch and the credit default swap (CDS) data (in relation to the CDS benchmark). The result is a **suggested** duration for lending, with an extensive list of institutions to choose from. The counterparty list based on the minimum credit ratings list has a narrower selection of banks to choose from, based on the Council's minimum lending criteria. Monetary and duration limits are as per the approved strategy.

The difference between the matrix counterparty list and the minimum credit rating counterparty list is that in the case of the latter the list is more restricted resulting in a superior credit quality of banks that qualify. The Council will continue to maintain both counterparty lists from Sector.

Sovereign Ratings

Many countries have ratings in their own right. In recent times, several have suffered downgradings (Ireland, Greece, Spain and Portugal for example) due to the financial crisis. Standard & Poor's have reduced the rating of both the USA and France to below AAA although, with Moody's also downgrading France. As at 31st January 2013 only Fitch is rating the USA and France AAA.

The continued use of Sovereign ratings may, ultimately, be counterproductive in relation to the UK. The success of the UK government's austerity programme in reducing the public sector deficit depends heavily on the economy as a whole. As nearly 50% of all UK exports go to the Euro zone, this inevitably raises a question mark over the potential for success of the UK austerity programme over the next two years which, in turn, increases the risk of one or more of the rating agencies downgrading the UK from AAA status over the next twelve months. As a result, it is recommended that, whilst retaining the requirement for other countries to have a AAA sovereign rating, this should not apply to the UK, as to retain it would remove the ability to make deposits in the DMO and other local authorities should the UK suffer a rating change.

Bank Call Accounts and Term Deposits

The current strategy (2012/13) with respect to bank deposits (calls accounts and term deposits) is one of suspension following a number of downgrades in bank credit ratings. The ongoing economic uncertainty, the Eurozone Sovereign debt crisis and banking sector turmoil, has further increased counterparty risk. In light of this the Council still has bank call accounts with the Bank of Scotland (part of the Lloyds/TSB group), National Westminster (part of the Royal Bank of Scotland group) and Santander, albeit with small nominal amounts. The exception to this is the Co-op Bank- the Council's banker.

It is proposed that the Council will continue with existing arrangements and reinstate its existing call accounts and open further calls (if required) when market and economic conditions stabilise, and when credit ratings meet the Council's minimum credit rating criteria. In the absence of bank call accounts and term deposits, the Council will continue to make use of the DMADF at the DMO as a means to managing liquidity risk, albeit at unfavourable interest rates. The Council will also continue to use the call account facility with the Co-Op bank, but only for overnight, weekend arrangements or to meet business continuity requirements.

Other short-term counterparties

Debt Management Office (DMO) – DMADF

This is, as Members are aware, the UK Government. It has been the counterparty of choice for 2012/13 due to the ongoing concerns regarding all other counterparties. However, the rates achievable from the DMO are very low (currently 0.25%), but deposits are considered to be at least risk in the current climate. Members will need to be aware that there is some probability of interest rates falling below the 0.25% if the Bank Rate (currently 0.50%) is reduced to stimulate the economy. If this is the case the impact of this rate cut will diminish investment income further.

DMO - UK Treasury Bills (T-Bills)

T-Bills have not been used in 2012/13 as the yields (interest returns) have been trading at rates below the DMADF. The cause of yields falling has been due to the ongoing Eurozone sovereign crisis as investors see the UK government as a safe haven for investments. Furthermore, the ongoing economic measures, such as quantitative easing and the Funding-to-Lend Scheme, undertaken by the Bank of England has driven down yields. Consequently, gilts and T-bills are oversubscribed with the inevitable result that the yields (interest returns) have fallen. As at 31/01/2013, T-bills continued to trade at rates below the DMADF.

The Council will only invest in T-Bills if rates improve and exceed the rate achievable with the DMADF.

Local Authorities

Whilst local authorities have always been regarded as having an implied AAA rating, only a handful of UK Authorities have public ratings as a means to raising alternative forms of debt finance in the capital markets. In the current economic cycle and program of austerity measures pursued by Central Government, credit rating agencies are concerned with the future funding implications for many local authorities in light of falling income streams and local authorities holding highly leveraged debt portfolios. This highlights a "downside risk" to the probability of default if there is no central government support. A view held by the main credit rating agencies.

Credit rating agencies actively monitor credit quality for over 150. These studies are usually commissioned by bank lenders to Authorities and are conducted without the co-operation of the authority, with studies based on publically available information. Given the limited scope of this type of credit estimate the ratings produced tend to be on the conservative side.

This clearly raises the question of how we should assess other local authorities for credit worthiness and what controls should be put in place. The 2012/13 Strategy recommended a monetary limit and maximum duration of £5m and 3 months respectively. However, it is worth considering policy in this area. While Local Authorities are likely to be amongst the highest quality counterparties on our list they are not all equal.

Using Arlingclose's matrix, local authorities that do not have an individual rating are given a score of 1.77 which is the average score of those authorities that are rated. However, it would be impractical to stipulate that deposits are made only with those local authorities that are rated as the numbers are too few. It would however be practical to stipulate that deposits should not be made with any local authority with a rating higher than two (equivalent to AA+).

AAA Rated Money Market Funds

Money Market Funds (MMFs) are pooled investments consisting of short-term money market instruments such as Certificates of Deposits (CDs), Treasury Bills, Gilts, etc. MMFs can be of a constant net asset value (CNAV) where the assets within the fund are valued at £1 per unit, or variable net asset value (VNAV) where assets prices fluctuate on a daily basis, and potentially result in a capital loss. Authorities (Capital Finance and Approved Investments) Regulations 2002, subsequently replaced by the Local Government Act 2003.

MMFs are rated by the Credit Rating agencies. The highest ratings being:

• Standard & Poor's	AAAm	Credit quality rating
• Moody's	Aaa-mmf MR1+	Credit quality rating and volatility rating
• Fitch	AAA-mmf V1+	Credit quality rating and volatility rating

Since their inception in the 1970's, no sterling CNAV AAA MMF has been downgraded by the rating agencies.

The benefits of using MMFs:

- Active management of cash balances for short periods
- Daily access
- AAA rated – higher rating than bank call accounts
- Enhanced returns due to 'pooled' sums, experienced investment managers.
- Diversification of risk
- Easy management of short-term cash.

The risks of using MMFs:

- Capital fluctuations – underlying assets e.g. CDs are subject to capital fluctuations as a result of interest rate and credit risk. The structure of the fund minimises the movement of capital value due to the restrictions laid down by the credit rating agencies. **This is only true if the MMF is a VNAV fund.**
- Credit risk- risk to capital

Principles of MMFs:

- Security – AAA rated
- Liquidity – daily access to funds
- Yield – overnight investment but with returns between 7 day and 1 month LIBID

It is proposed that CNAV MMFs be considered for use as and when Members feel that the markets have become suitably stable. Due to the risk of capital loss, the current capital finance regulations classify MMFs as non-specified investments and are treated as capital expenditure.

b) Investment periods

- **Short-term (up to 364 days)**

At the time of writing, all short-term investments are managed in-house as a result of day-to-day cash flow management.

For the purpose of flexibility to respond to day-to-day cash flow demands, the proposed minimum percentage of its overall investments that the Council will hold in short-term investments is **30%**.

Members are reminded that once a deposit has been made for a fixed period it can only be withdrawn (repaid early) by mutual consent.

- **Long-term (one year and over)**

Currently the Authority has no long-term investments. Should the decision be taken to invest in non-specified investments, it is suggested that no more than £5m be placed with any one institution with duration of no longer than **two years.**

c) Target Rate

Forecasts of base rates can be quite diverse as illustrated by the table in ***Appendix 2***. In view of the uncertainty inherent in such predictions, it would be imprudent to set a target rate which may be difficult to achieve. In view of the foregoing, it is proposed to set a target rate of return for short-term deposits in 2013/14 of no more than **0.25%.**

This rate reflects the forecast of Bank Rate and the relationship between that rate and the rate achievable from the DMADF. If deposits are made with other counterparties as detailed in Section (a) of this Appendix, it is possible that the above rate could be exceeded.