

Updated Creditworthiness Report

Historically, Sector has used a creditworthiness service based on distributing information provided by credit rating agencies (Fitch & Moody's). In addition, Sector has then, based on certain minimum criteria, assigned colours to individual counterparties which indicate a suggested duration for that counterparty.

However, it has been proven since the unprecedented events in the market in 2008, that credit rating agencies have a delay when responding to market events and thus do not provide investors with an 'up to date' picture of the credit quality of a particular institution.

In light of this, Sector has introduced from April 2009 Credit Default Swap (CDS) Spreads as an overlay to the credit ratings. CDS spreads provide perceived market sentiment regarding the credit quality of an institution. Since they are traded instruments, they indicate the market perception related to that entity's credit quality. Credit ratings look at a firm's fundamentals i.e. its balance sheet, income statement etc. and tend to focus on a longer-term view of the firm.

The enhanced service adds a subjective CDS overlay (CDS data is sourced from Bloomberg) providing clients with additional data and analysis to aid in making more informed credit decisions.

However, it is important to note that not all entities on the list will have an actively traded CDS spread.

The following extracts show the changes in the information included in the new Creditworthiness Reports provided by Sector (the example relates to Abbey):

Previous data

Short-term Duration	Long-term Duration	Long-term	Short-term	Individual	Support
Red	Orange	AA-	F1+	B	1

'Enhanced' Data

Long-term	Short-term	Individual	Support	Duration	CDS Data 07/08/09	(Below)/Over Benchmark	(Below)/Over Benchmark (%)	CDS Status	Adj Duration
AA-	F1+	B	1	Orange	65.525	(26.475)	(29.75%)	In Range	Orange

Other column headings not shown above (for reasons of presentation) are:

- CDS Data for previous two weeks
- Week % Change
- 3 Month % Change

The above give an indication of how the data are moving from week to week.

Definitions - Previous Reports:

- Short-term Duration – Red. Lending up to **one** year
- Long-term duration – Orange. Lending up to **two** years

Definitions – Current Reports:

- Duration – Orange. Lending up to **six** months (Other durations/colours are Green/One Month, Red/Three months, Purple/One year).
- Benchmark – this is a index published by a leading company (Markit) in CDS pricing and valuation
- CDS Status – In Range. The CDS spread is less than the benchmark. This is a favourable indicator (Other rankings are Monitoring – reduces colour by one level i.e. Red to Green, and Out-of-Range – automatically reduces colour to No Colour –an unfavourable rating)

Whilst still adopting a ‘matrix’ approach, the overall duration for investments has been reduced to reflect the more volatile circumstances still prevalent in the financial markets.

As at 21st August 2009, using the most practical level of criteria, being AA-,F1+,B,1, twelve banks remain on the Creditworthiness list . Of these, only two (Barclays and Abbey) are likely to be suitable counterparties for the Council in that they take deposits at the levels and periods at which we operate. Clearly, should we decide to review our use of the Market, with a maximum exposure level of say £2m -£5m with any institution, the majority of the Council’s funds would still need to be deposited with the Debt Management Office.

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 started in the US in the 1970’s and developed in Europe in the 1980’s. In the EU, these funds are governed by UCITS (Undertakings of Collective Investments in Transferable Securities). Local Authorities were allowed to use MMFs from April 2002 under the Local 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 MR1+ | Credit quality rating and volatility rating |
| • Fitch | AAA V1+ | Credit quality rating and volatility rating |

Since their inception in the 1970’s, no sterling 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.

Principles of MMFs

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

Currently, funds are returning yields in the region of 0.75% to 0.80%, well above the return available from the DMADF.

However, to place these figures in context, if we decided to invest £5m in a fund, the additional interest achievable, assuming the balance remained in the fund for a full year, would be in the region of £30k.