Appendix 2

Updated Creditworthiness Report

The CIPFA paper (March 2009) – 'Treasury Management in Local Authorities – Post Icelandic Banks Collapse' made the following statement with regard to credit ratings:

'There has been much debate about the role of credit ratings and their use by local authorities. Credit ratings remain a key source of information but it is important to recognise that they do have limitations. ***Authorities are advised to have regard to the ratings issued by all three main agencies****, Fitch, Moodys and Standard and Poor, and to make their decisions on the basis of the lowest rating. Ratings should be kept under regular review and 'ratings watch' notices acted upon'.*

In Sector's view, following this directly would severely reduce the number of institutions, making the credit list almost redundant and is, therefore, not practical.

In simple terms, the revised methodology incorporates Standard & Poor's ratings and provides a mathematical and transparent approach. The system assigns values to the ratings of all three agencies as follows:

	Fitch				Moody's			S & P	
	L/Term	S/Term	Indiv	Support	L/Term	S/Term	FSR	L/Term	S/Term
'A Bank'	AA-	F1+	B	1	Aa1	P-1	B	AA	A-1+
Scoring	4	1	3	1	2	2	3	3	1

The individual scores above are averaged with a result being placed within pre-determined bands to determine its colour and ultimately its duration for investment. The bands are colour coded as follows:

- Purple – Two Years – 4.00 to 8.50
- Orange – One Year – 8.50 to 10.50
- Red – Six Months – 10.50 to 12.50
- Green – Two Months – 12.50 to 14.50
- No Colour – No duration – 14.50 and above

The average score from the example above is 8.33 and would therefore sit within the Purple band with an investment duration of up to two years.

The average is calculated by adding the individual like elements together and averaging the resultant figure e.g.:

- Long term = 4+2+3 = 9/3 = 3
- Short term = 1+2+1 = 4/3 = 1.33
- Individual (Fitch and Moody) = 3+3 = 6/2 = 3
- Support (Fitch only) = 1

The sum of those averages equals 8.33

The duration shown above has been doubled from the current periods to reflect the perceived strengthening market.

This still applies a four-way approach, however if a rating is missing and subsequently restricts the four-way approach, then the duration is reduced by one colour band.

Following the CIPFA guidance, the new system also takes into account both negative and positive outlooks and rating watches from all three rating agencies. In the case where a negative watch or outlook has been placed on the institution a 1 is added to the score and 1 is subtracted if a positive

watch or outlook has been assigned. This strategy assumes that the up/down grade has already happened and allows the benefit of a positive movement to be reflected in the institutions score and conversely reduces the score if a negative movement is indicated.

By doing this the score above of 8.33, indicating a two-year investment period, would become 9.33 with a negative outlook, therefore moving into the orange band, resulting in a shorter investment period.

To the above Sector have also reviewed their use of the Credit Default Swap (CDS) overlay. The CDS benchmark is based on the iTraxx Senior Financials index of 26 major banks. This figure is currently at the level that it was before Lehman Bros bank collapsed a year ago. The current method used by Sector to incorporate CDS data within their credit worthiness monitoring is as follows:

- CDS spread < Benchmark = In Range (counterparty meets complete credit criteria, including credit ratings)
- CDS spread < Benchmark + 50 bps = Monitoring (counterparty has been put on 'watch' and consequently has a reduction in its initial investment duration)
- CDS spread > Benchmark + 50 bps = Out of Range (counterparty does not meet credit criteria and is reduced to 'no colour' and has no investment duration)

The new system will use a minimum of either the iTraxx plus 50 bps or 0.5x standard deviation of the CDS spreads for the day in question as the upper band.

The reason that this approach has been taken means, according to Sector, the use of a standard deviation function results in a relative measure of volatility in the spreads thus determining the appropriate band.

Thus, in Sector's view, their new methodology for credit worthiness compensates for the restrictive guidance from CIPFA, uses all three rating agencies, takes into account all variables and provides a practical approach and, more importantly, allows Local Authorities to have a workable credit list.