The Counterparty Policy

Introduction

1. The counterparty policy considers the entities to which the Council will invest its cash balances and the maximum balance it will invest with each entity. Historically, funds have been invested with UK and international banks, UK building societies and money market funds. Prior to 2008, confidence in the creditworthiness of financial institutions was high and credit ratings didn't play quite such a central role in counterparty selection. For example, Harrow and other LBs were prepared to invest in unrated building societies.

2. Since 2008 the challenges faced in investing Council funds has intensified. Financial institutions have defaulted and credit ratings continue to fall below levels that would in the past be considered safe. Bank that were once rated AAA are now A- and might soon be BBB. Part of this is a realisation that historic ratings were overly generous. An added challenge is the fall in interest rates that requires credit and / or duration risks to be taken to generate returns in excess of 0.5%.

3. In response to these developments, Harrow's counterparty policy has been amended twice in the last year and the portfolio is very different to how it looked pre 2008. The amendments have involved recognition that Lloyds and RBS, being part owned by the UK Government, are in a different, lower, risk category than other banks and merit higher maximum allocations. We have therefore raised the maximum limit on deposits with each of these two banks from 20% to 30% and most recently to 50% each of total deposits. Secondly, the required long term and short term ratings have been lowered by one or two levels to A (from AA-) and F1 (from F1+). Full use has been made of the increased limits for Lloyds and RBS as these banks throughout 2012 offered substantially higher returns on deposits. As a consequence, the portfolio has become much more concentrated with Lloyds and RBS now representing over 90% of investments.

4. Keen to stimulate lending and boost the economy, the Government and the Bank of England funding have made available low cost funds to banks and building societies. The impact has been that the rates on offer for one year and longer terms collapsed in 2012 and are now hovering below or just above 1%. In 2011, rates as high as 3% were briefly available for 1 year deposits.

Enhanced Cash Funds

5. The potential investment universe is wide and there are many types that Harrow does not currently utilise. One category that we would like to introduce into the portfolio is enhanced cash funds (also known as short dated bond funds). These share many of the characteristics of money market funds, which Harrow already uses:

   - Stand alone fund, mainly a Dublin plc, that invests in bank and corporate bonds, bank deposits and other financial instruments.
   - An appointed fund manager determines which investments to hold.
   - Investment is through the purchase of units.
   - Most have an AAA credit rating.

6. The key difference between money market (MM) funds and enhanced cash (EC) funds is the latter are permitted longer maximum average maturities. A rated MM fund has a maximum weighted average maturity (WAM) of 60 days, while EC funds typically have 360 days WAMs and many longer. This allows them to generate a higher return from buying longer dated securities. As a consequence of the longer WAM, there are a number of consequential differences between MM and EC funds:

- The value of investments in EC funds can vary being based on the underlying value of the investments. In a MM fund, any change in value is relatively small (unless a counterparty defaults) and is reflected in the declared income.
- MM funds are dealt daily with cash moving in and out on trade date. With EC funds the notice and settlement period can be up to 5 days and the funds are not suitable for intra day liquidity.
- EC funds employ a wider range of instruments and sometimes use derivatives.

7. EC funds are attractive to Harrow in that they offer a higher return than MM funds and compared with direct investments in bonds offer high levels of diversity while maintaining an overall high quality credit exposure.

8. As mentioned above, most EC funds have a credit rating, usually AAA. There is also a separate volatility rating that measures the sensitivity of the value of the fund to changes in interest rates. When market interest rates increase, the impact on the value of longer term investments is higher than short term investments. Despite the longer WAM, many have the lowest volatility ratings because they have strict policies on selling investments when prices change.

9. The attraction of EC funds is the higher returns. MM funds generally have net returns at present of between 0.3% and 0.6%, where as an EC fund with a WAM of 360 days is currently in the range 1% to 2%.

10. The use of such funds has been discussed with the Council's treasury advisor who are supportive provided the exposure is limited to 20-25% of the total deposits and we invest with higher security / lower volatility funds. Sector has an established service to advise on fund selection, priced at approximately £5,000. We will avoid funds that use derivatives as the legality of these for local authorities is unclear. Implementation will involve both a switch from MM funds and bank fixed term deposits. A maximum of £10 million invested with a single fund is proposed.

11. A proposed counterparty policy including the use of EC funds is shown below.

Other opportunities

12. In reviewing the universe of opportunities, we also considered:

- Increasing the maximum maturities for Barclays and Nationwide from 3 months to 12 months.
- Introducing new counterparties e.g. Co-op banks and smaller building societies with a 12 month maximum maturity.
- Repaying existing debt

13. Each of these offered immediate gains. However, the first two offered returns either in line with or lower than EC funds. Repaying debt had a long term significant cost due to the premiums payable.

Revised Counterparty Policy

Specified Investments (no changes)

Maximum maturity 12 months

Instrument	Minimum Credit Criteria	Use
Debt Management Agency Deposit Facility	Government backed	In-house
Term deposits – other LAs	Local Authority issue	In-house
Term deposits – banks and building societies	AA- Long Term F1+Short-term 2 Support UK or AAA Sovereign	In-house
Money Market Funds	AAA	In-house

Non-Specified Investments

	Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period
Term deposits – banks and building societies	A Long Term F1 Short-term 1 Support UK or AAA Sovereign	In-house	50%	3 months
UK nationalised Banks [RBS & Lloyds / HBOS]	F1 Short-term 1 Support	In-house	50% for each of the two Groups	36 months
Callable Deposits	F1 Short term A Long Term 1 Support	In-house	20%	3 months
Enhanced Cash Funds	**AAA Credit V1 or V2 volatility Minimum fund size £500 million**		**25% Maximum £10 million per fund**	**N/A**

14. Maturities for term deposits with banks and buildings societies that meet the credit quality threshold for specified investments will also be restricted to three months.