REPORT FOR:	**Governance and Risk Management COMMITTEE**
Date of Meeting:	1 December 2011
Subject:	Creditworthiness and Counterparty Policy
Responsible Officer:	Julie Alderson, Interim Director of Finance
Exempt:	No
Enclosures:	Appendix 1 – current creditworthiness and counterparty policy. Appendix 2 – Revised counterparty policy for non specific investments. Appendix 3 – CLG guidelines Appendix 4 – Fitch ratings definitions

Section 1 – Summary and Recommendations

This report proposes changes to the counterparty policy in response to recent revisions to UK bank credit ratings while continuing to emphasise the prudent management of the investment portfolio.

Recommendation:
The Committee is requested to

(1) recommend to Council for approval the revised counterparty policy for non-specific investments set out in appendix 2, and

(2) if approved for recommendation, to consider whether to submit the report to Cabinet for comment prior to Council approval.

Harrow COUNCIL
LONDON

Section 2 – Report

Introduction

1. The Council's short term investments are placed with banks and buildings societies selected in accordance with the creditworthiness policy set out in the annual treasury strategy. Recent downward revisions to UK bank credit ratings mean that most of our active counterparties no longer achieve the required minimum ratings. This paper proposes changes to the treasury strategy to address these developments, while continuing to prudently manage the cash portfolio. In particular the required minimum credit quality for the main UK high street banks have been lowered in line with current ratings, while maximum maturities have been reduced to reflect greater uncertainty.

Current Counterparties

2. The Council's temporary cash balances are invested with banks, buildings societies and money market funds. The eligible institutions to receive funds are determined by credit quality guidelines as set out in the annual treasury strategy. The primary concern when investing Council funds is capital preservation and for that reason eligible institutions have been limited to those with very highest credit quality, defined as a minimum of:

	Banks & Buildings Societies	Nationalised Banks (RBS, Lloyds/HBOS)	Instant Access deposits
Long term rating	AA-		A
Short term rating	F1+	F1+	F1+
Support	2	1	
Individual	B		
Country	AAA		

3. The main counterparties used for Council investments are:

Royal Bank of Scotland [The Council's bankers]
Lloyds / HBOS
Barclays
Santander UK
Nationwide Buildings Society
Svenska Handelsbanken
Money Market Funds [all AAA rated]

Recent Events

4. Prior to 13th October, all these banks achieved the required credit quality. Since then the Fitch short term ratings of Lloyds/HBOS, RBS, Santander UK and Halifax have been cut by one level to F1 and the long term ratings by either one level to A+ (Santander UK and Nationwide) or two levels to A (Lloyds/HBOS and RBS). These banks no longer meet our established minimum credit requirements.

5. In response to the downgrades, Council monies held on instant access call account with RBS were withdrawn and invested in money market funds. In line with treasury policies, we did not attempt to renegotiate fixed term deposits of £73 million with the downgraded banks. As of 10 November 2011, only £49.4 million (out of £122 million) is invested with counterparties (Barclays, Svenska and money market funds) that meet our current credit quality guidelines.

Treasury Advisor Recommendation

6. The Council's treasury advisor, Sector, provides recommended maximum maturities for the major UK and overseas banks. These are based on current credit ratings adjusted for impending reviews and for UK banks range from 0 months (no deposits) to 24 months. Sector further refines the maturities by factoring in the implied ratings from credit default spreads. The adjusted maximum maturity recommendation for Harrow's current counterparties is:

12 months – RBS & Lloyds/HBOS
3 months – Barclays, Santander UK, Nationwide & Svenska

7. Privately, Sector has stated that its suggested maturities could be extended for the two part nationalised banks.

"Our advice is to follow the suggested duration limits we have set in our weekly credit report. However, as regards the part nationalised banks, RBS Group and Lloyds Bank, you could consider going beyond the 1 year suggested limit towards a suggested limit of 2/3 years based on the current view in the market that they are unlikely to return to pure private ownership and therefore pure banking risk for some time yet, which could extend beyond 1 year and perhaps by as much as up to 3 years. As they are part government risk, you could consider increasing the limits to an amount which represents a higher percentage of total perceived cash balances over this period. This could be as high as 30% for each of the two Groups, so that the overall Group exposure is taken into consideration."

8. The above analysis is based on an assumption that the level of support for the part nationalised banks is greater than for the other UK High Street banks. The proposals herein are more even handed and also recognise the stronger financial position of the banks that did not require government support.

Proposed Action

9. In recent years we have agreed with Sector's cautious definition of eligible banks, but have placed funds for periods up to three years, in line with the policy that no more than £25 million should be invested for more than a year. Our view has been that when banks default it is instantaneous; they are either seen as solvent or they fold. When confidence goes it happens quickly and a three months maturity does

not offer any particular window of opportunity. Thus if we are prepared to invest with a bank, then modestly longer maturities are as safe as rolling short term maturities.

10. The current annualised yields available from the counterparty banks are:

Instant access	0.80%
3 months	0.98%
12 months	1.80%
24 months	3.35%

11. It can be seen that there is considerable additional income available from lending longer term e.g. £10 million invested for two years will generate £255,000 per annum more in interest than the same balances invested overnight.

12. The CLG treasury guidance (appendix 3) requires priority (in order) to security, liquidity and yield. However, the guidance adds "that does not mean that authorities are recommended to ignore such potential revenues [investment income]. Once proper levels of security and liquidity are determined, it will then be reasonable to consider what yield can be obtained consistent with those priorities." In the light of the above guidance, the proposals below involve a change to the minimum acceptable credit limits and entail maximum maturities potentially longer than the Sector guidance.

13. The security of the UK High Street banks is considered to remain high reflecting past Government action and also the historical impact of allowing a bank to fail. All the UK banks & building societies currently used have top rated support level of 1 from Fitch. On this basis, we are proposing amending the counterparty policy to enable continued utilisation of the UK banks listed in 3 above.

14. The current guidelines restrict deposits with a maturity of more than 12 months to £25 million (approximately 20% of balances) and within that deposits of up to 5 years maturity are permitted. It is recommended that the £25 million limit is retained for the current year, but reviewed annually in anticipation of the reduction of investment balances. In light of the economic uncertainties a five year maximum maturity is questionable and a revised maximum maturity for new deposits of 24 months is proposed, again to be reviewed annually.

15. To reflect the above changes, the guidance for non-specified investments has been amended (see appendix 2). The changes are seen as balanced in that they combine weaker long & short term ratings, but shorter maturities and higher support ratings.

16. Individual bank limits within the overall credit guidelines are set by the S151 officer. The current limit of £20 million per bank will be retained. The Lloyds/HBOS combined limit of £30 million will be reduced to £20 million. Deposits with non UK banks will be required to meet the criteria for specified investments.

Conclusion

17. These proposals strike a balanced approach to security, liquidity and yield, accepting the pre-eminence of the first two yet recognising that an overly cautious approach will entail a loss of investment income.

18. The revised strategy will be kept under review and formally reported to Cabinet three times a year within the strategy, half-yearly & annual reports. Changes in ratings are monitored at least monthly by the Treasury Management Group.

Financial Implications

19. Interest on the Council's investment balances is projected to generate £1.8 million gross (£1.2 million net after internal allocations), representing an average rate of 1.65% on average balances this year of £122 million. The proposed revised counterparty strategy is consistent with retaining current income levels.

Risk Management Implications

20. Risk included on Directorate risk register? Yes.

21. Separate risk register in place? No

22. The risk of loss of an investment is rated green due to the very low likelihood based on active monitoring of counterparties. The paper fully discusses the risk implications of changing the minimum required credit ratings.

Equalities implications

23. Was an Equality Impact Assessment carried out? No.

24. There are no direct equalities implications as no individual is impacted by the proposals.

Corporate Priorities

25. Treasury activities have no direct impact on Council priorities, although through revenue generation they have an indirect impact on all the priorities.

Section 3 - Statutory Officer Clearance

Name: Julie Alderson Date: 18 November 2011	√	Chief Financial Officer
Name: Matthew Adams Date: 22 November 2011	√	on behalf of the Monitoring Officer

Section 4 - Contact Details and Background Papers

Contact: George Bruce (Treasury & Pension Fund Manager) Tel: 020-8424-1170 / Email:george.bruce@harrow.gov.uk

Background Papers: February 2011 Treasury Strategy Report to Cabinet.

If appropriate does the report include the following considerations?

1.	Consultation	NO
2.	Corporate Priorities	YES

Extract from the Annual Investment Strategy

Investment Policy

23. The Council approves a Treasury Management Strategy on an annual basis and has adopted the 'CIPFA code of Practice for Treasury Management in the Public Services'.

24. The Council will have regard to the CLG's Guidance on Local Government Investments ("the Guidance") and the 2009 revised CIPFA Treasury Management in Public Services Code of Practice and Cross Sectoral Guidance Notes ("the CIPFA TM Code"). The Council's investment priorities are: -

    (a) The security of capital, and
    (b) The liquidity of its investments.

25. The Council will also aim to achieve the optimum return on its investments commensurate with proper levels of security and liquidity. The risk appetite of the Council is low in order to give priority to security of its investments.

26. The borrowing of monies purely to invest or on-lend and make a return is unlawful and the Council will not engage in such activity.

Creditworthiness and Counterparty Policy

27. Investment instruments identified for use in the financial year are listed below under the 'Specified' and 'Non-Specified' Investments categories.

28. Counterparty limits are approved by the Section 151 Officer in accordance with the Council's Treasury Management Practices. At present, each approved counterparty has a £20 million limit, which is further restricted to a group limit of £30 million e.g. Lloyds / HBOS.

29. Specified investments are considered low risk and relate to funds invested for up to one year. Non-Specified investments sometimes offer the prospect of higher returns but carry a higher risk and may have a maturity beyond one year. All investments and borrowing are sterling denominated.

Specified Investments

30. All such investments will have maturities up to maximum of 1 year, meeting the minimum rating criteria where applicable. The instruments and credit criteria to be used are set out in the table below.

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 B Individual AAA Sovereign	In-house
UK Nationalised banks	F1+ Short-term 1 Support	In-house
Money Market Funds	AAA	In-house

<u>Non-Specified Investments</u>

	Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period
Term deposits – banks and building societies	AA- Long Term F1+ Short-term 2 Support B Individual AAA Sovereign	In-house	50%	5 yrs
Callable Deposits	F1+ Short term A Long Term	In-house	20%	5 yrs

31. All credit ratings will be monitored in house with the help of Sector who alert the Council to changes in Fitch ratings through its creditworthiness service. Opportunities to use credit default swap costs and other financial information to anticipate changes in credit quality are being considered.

32. If a downgrade results in the counterparty no longer meeting the Council's minimum criteria, its further use as an investment will be withdrawn immediately.

Appendix 2

Non – specified Investments (Revised)

	Minimum Credit Criteria	Use	Max % of total investments	Max. maturity period
Term deposits – banks and building societies	**A** Long Term [**AA-**] **F1** Short-term [**F1+**] **1** Support [**2**] B Individual **UK** or AAA Sovereign	In-house	50%	**24** months [**5 years**]
Callable Deposits	F1 Short term [**F1+**] A Long Term **1 Support**	In-house	20%	**3 months** [**5 years**]

Changes to the current counterparty policy are highlighted in [ ].

Extract

Department for Communities and Local Government
GUIDANCE ON LOCAL GOVERNMENT INVESTMENTS
Issued under section 15(1)(a) of the *Local Government Act 2003*
and effective from 1 April 2010

(4) INVESTMENT STRATEGY
Preparation
4.1 The Secretary of State recommends that for each financial year a local authority should prepare at least one investment Strategy ("the Strategy") in accordance with the timetable in paragraphs 4.5 and 4.6.

4.2 The Strategy should set out the authority's policies for the prudent management of its investments and for giving priority, firstly, to the security of those investments and, secondly, to their liquidity. It should therefore identify the procedures for monitoring, assessing and mitigating the risk of loss of invested sums and for ensuring that such sums are readily accessible for expenditure whenever needed.

(5) INVESTMENT SECURITY

Specified investments
5.1 An investment is a ***specified investment*** if all of the following apply:

(a) the investment is denominated in sterling and any payments or repayments in respect of the investment are payable only in sterling;

(b) the investment is not a *long-term investment* (as defined in paragraph 2.4);

(d) the investment is made with a body or in an investment scheme of *high credit quality* (see paragraph 5.2); or with a public-sector body.

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5.2 For the purposes of paragraph 5.1(d), the Secretary of State recommends that the Strategy should define *high credit quality* (and where this definition refers to *credit ratings*, paragraph 6.1 is relevant).

Non-specified investments

5.3 With regard to ***non-specified investments*** (.i.e. those not meeting the definition in paragraph 5.1), the Secretary of State recommends that the Strategy should:

(a) set out procedures for determining which categories of such investments may prudently be used (and where these procedures involves the use of *credit ratings*, paragraph 6.1 is relevant);

(b) identify which categories of such investments have so far been identified as prudent for use during the financial year; and

(c) state the upper limits for the amounts which, at any time during the financial year, may be held in each identified category and for the overall amount which may be held in non-specified investments (the limits being defined by reference to a sum of money or a percentage of the authority's overall investments or both).

(6) INVESTMENT RISK

Risk assessment

6.1 The Secretary of State recommends that the Strategy should state the authority's approach to assessing the risk of loss of investments, making clear in particular:

> (a) to what extent, if any, risk assessment is based upon credit ratings issued by one or more credit rating agencies;
>
> (b) where credit ratings are used, how frequently credit ratings are monitored and what action is to be taken when ratings change; and
>
> (c) what other sources of information on credit risk are used, additional to or instead of credit ratings.

(7) INVESTMENT LIQUIDITY

7.1 The Secretary of State recommends that the Strategy should set out procedures for determining the maximum periods for which funds may prudently be committed.

Comments from the guidance notes

The generation of investment income is distinct from these prudential objectives and is accordingly not a matter for the guidance. However, that does not mean that authorities are recommended to ignore such potential revenues. Once proper levels of security and liquidity are determined, it will then be reasonable to consider what **yield** can be obtained consistent with those priorities.

Appendix 4

Fitch Rating Definitions

Long Term Ratings

AA Very high credit quality – Expectation of very low credit risk. Strong capacity for payment of financial commitments.

A High credit quality – Expectations of low credit risk. The capacity for payment of financial commitments is considered strong. This capacity may be more vulnerable to adverse business or economic conditions than is the case for higher ratings.

Short Term Ratings

F1 Highest short term credit quality – Indicates the strongest intrinsic capacity for timely payment of financial commitment; may have an added "+" to denote any exceptionally strong credit feature.

Support Ratings

1 Denotes a bank for which there is an extremely high probability of external support. The potential provider of support is very highly rated in its own right.

2 A bank for which there is a high probability of external support.

Individual Bank Ratings

A Very strong Bank

B A strong bank. There are no major concerns regarding the bank.