

## **Treasury Management Practice (TMP) 1 – Credit and Counterparty Risk Management**

The CLG issued Investment Guidance in 2010, and this forms the structure of the Council's policy below. These guidelines do not apply to either trust funds or pension funds which are under a different regulatory regime.

The key intention of the Guidance is to maintain the current requirement for Councils to invest prudently, and that priority is given to security and liquidity before yield. In order to facilitate this objective the guidance requires this Council to have regard to the CIPFA publication Treasury Management in the Public Services: Code of Practice and Cross-Sectoral Guidance Notes. This Council has adopted the Code and will apply its principles to all investment activity. In accordance with the Code, the Strategic Director for Resources has produced its treasury management practices (TMPs). This part, covering investment counterparty policy requires approval each year.

**Annual Investment Strategy** - The key requirements of both the Code and the investment guidance are to set an annual investment strategy, as part of its annual treasury strategy for the following year, covering the identification and approval of following:

- The strategy guidelines for choosing and placing investments, particularly non-specified investments.
- The principles to be used to determine the maximum periods for which funds can be committed.
- Specified investments the Council will use. These are high security (i.e. high credit rating, although this is defined by the Council, and no guidelines are given), and high liquidity investments in sterling and with a maturity of no more than a year.
- Non-specified investments, clarifying the greater risk implications, identifying the general types of investment that may be used and a limit to the overall amount of various categories that can be held at any time.

The investment policy proposed for the Council is:

**Strategy Guidelines** – The main strategy guidelines are contained in the body of the treasury strategy statement.

**Specified Investments** – These investments are sterling investments of not more than one-year maturity, or those which could be for a longer period but where the Council has the right to be repaid within 12 months if it wishes. These are considered low risk assets where the possibility of loss of principal or investment income is small. These would include sterling investments which would not be defined as capital expenditure with:

1. The UK Government (such as the Debt Management Account deposit facility, UK Treasury Bills or a Gilt with less than one year to maturity).
2. A local authority, parish council or community council.
3. Pooled investment vehicles (such as money market funds) that have been awarded a high credit rating by a credit rating agency. For category 3 this covers pooled investment vehicles, such as money market funds, rated AAA by Standard and Poor's, Moody's or Fitch rating agencies.
4. A body that is considered of a high credit quality (such as a bank or building society). For category 4 this covers bodies with a minimum short term rating of F1 (or the equivalent) as rated by Standard and Poor's, Moody's or Fitch rating agencies.

Within these bodies, and in accordance with the Code, the Council has set additional criteria to set the time and amount of monies which will be invested in these bodies. This criteria is

	<b>Fitch Rating</b>	<b>Moody's Rating</b>	<b>Standard &amp; Poor's Rating</b>	<b>Money Limit</b>	<b>Time Limit</b>
Upper limit category	F1+/ AA-	P-1/Aa3	A-1+/AA-	£5m	3 yrs
Middle Limit Category	F1/A-	P-1/A3	A-1/A-	£2m	364 days
Other Institution Limits (other Local Authorities, Money Market Funds, DMADF)				£5m	364 days
Guaranteed Organisations				Within the terms of the guarantee to a maximum of £1m up to 6 months	

**Non-Specified Investments** – Non-specified investments are any other type of investment (i.e. not defined as Specified above). The identification and rationale supporting the selection of these other investments and the maximum limits to be applied are set out below. Non specified investments would include any sterling investments with:

		Limit £
a	Building Societies not meeting the requirements under specified investments – the operation of some building societies does not require a credit rating, although in every other respect the security of the society would match similarly sized societies. The Council may use such building societies which were originally considered Eligible Institutions and have a minimum asset size of £1bn but will restrict these investments to a maximum of £1m for up to 6 months.	£1m for up to 6 months
b	Gilt edged securities with a maturity of greater than one year. These are Government bonds and so provide the highest security of interest and the repayment of principal on maturity. The value of the bond may rise or fall before maturity and losses may accrue if the bond is sold before maturity	£5m for up to 3 years
c	A body which has been provided with a government issues guarantee for wholesale deposits within specific timeframes. Where these guarantees are in place and the government has an AAA sovereign long term rating these institutions will be included within the Council's criteria temporarily until such time as the ratings improve or the guarantees are withdrawn. Monies will only be deposited within the timeframe of the guarantee.	Within the terms of the guarantee to a maximum of £1m up to 6 months.
d	A body which is an Eligible Institution for the HM Treasury Credit Guarantee Scheme initially announced on 13 October 2008.	Within the terms of the guarantee to a maximum of £1m up to 6 months.
e	The Council's own banker if it fails to meet the basic credit criteria. In this instance balances will be minimised as far as is possible.	

**The Monitoring of Investment Counterparties** - The credit rating of counterparties will be monitored regularly. The Council receives credit rating information (changes, rating watches and rating outlooks) from Sector daily and when ratings change, and counterparties are checked. On occasion ratings may be downgraded when an investment has already been made. The criteria used are such that a minor downgrading should not affect the full receipt of the principal and interest. Any counterparty failing to meet the

criteria will be removed from the list immediately by the Strategic Director for Resources, and if required new counterparties which meet the criteria will be added to the list.

## Security, Liquidity and Yield Benchmarking

**Benchmarking and Monitoring Security, Liquidity and Yield in the Investment Service** - A proposed development for Member reporting is the consideration and approval of security and liquidity benchmarks.

These benchmarks are targets and so may be breached from time to time. Any breach will be reported, with supporting reasons in the Annual Treasury Report.

Yield – These benchmarks are currently widely used to assess investment performance. Local measures of yield benchmarks are:

- Investments – Internal returns above the 7 day LIBID rate

Security and liquidity benchmarks are already intrinsic to the approved treasury strategy through the counterparty selection criteria and some of the prudential indicators. However they have not previously been separately and explicitly set out for Member consideration. Proposed benchmarks for the cash type investments are below and these will form the basis of future reporting in this area. In the other investment categories appropriate benchmarks will be used where available.

Liquidity – This is defined as “having adequate, though not excessive cash resources, borrowing arrangements, overdrafts or standby facilities to enable it at all times to have the level of funds available to it which are necessary for the achievement of its business/service objectives” (CIPFA Treasury Management Code of Practice). In respect of this area the Council seeks to maintain:

- Bank overdraft - £0m
- Liquid short term deposits of at least £1m available with a week’s notice.

The availability of liquidity and the term risk in the portfolio can be benchmarked by the monitoring of the Weighted Average Life (WAL) of the portfolio – shorter WAL would generally embody less risk. In this respect the proposed benchmark is to be used:

- WAL benchmark is expected to be 0.2 years, with a maximum of 0.75 years.

Security of the investments – In context of benchmarking, assessing security is a much more subjective area to assess. Security is currently evidenced by the application of minimum credit quality criteria to investment counterparties, primarily through the use of credit ratings supplied by the three main credit rating agencies (Fitch, Moody’s and Standard and Poors). Whilst this approach embodies security considerations, benchmarking levels of risk is more problematic. One method to benchmark security risk is to assess the historic level of default against the minimum criteria used in the Council’s investment strategy.

The table beneath shows average defaults for differing periods of investment grade products for each Fitch long term rating category over the period 1990 to 2010.

Long term rating	1 year	2 years	3 years	4 years	5 years
AAA	0.00%	0.00%	0.00%	0.00%	0.00%
AA	0.04%	0.04%	0.08%	0.06%	0.09%
A	0.09%	0.27%	0.45%	0.56%	0.69%
BBB	0.24%	0.80%	1.42%	2.00%	2.62%

The Council's minimum long term rating criteria is currently "A" meaning the average expectation of default for a one year investment in a counterparty with a "A" long term rating would be 0.09% of the total investment (e.g. for a £1m investment the average loss would be £900). This is only an average - any specific counterparty loss is likely to be higher - but these figures do act as a proxy benchmark for risk across the portfolio.

The Council's maximum security risk benchmark for the whole portfolio, when compared to these historic default tables, is:

- 0.1% historic risk of default when compared to the whole portfolio.