

APPENDIX B

BANKING STRATEGY / LENDING COUNTERPARTIES REVIEW

PROPOSED 5 TIER STRATEGY

Background

- In the wake of the recent turmoil in the financial markets and its impact on the banking sector a review of lending strategy has been undertaken by the Finance Department.
- The review has produced a number of proposals to enhance current procedures.

The Issues

- The review has taken into account information received from a number of other London Boroughs, detailing their cash investment strategies, and any revised procedures which are currently under consideration.
- Any review of lending strategy should consider 3 major issues, that is credit ratings, limits on investments and investment periods. The aim is to maximise returns on investments and to minimise the risk of financial loss arising from possible default. There will be a trade-off between these 2 aims, but the over-riding consideration must be the security of cash deposits.
- The Council's current investment strategy is based on minimum Fitch Ratings, that is **Long Term A, Short Term F2, Individual B, Support 2.**

The Long Term Rating of **A** indicates a low level of long term risk; high credit quality; and a strong capacity to fulfil financial commitments.

The Short Term Rating of **F2** indicates good credit quality, and a satisfactory capacity to meet short term financial commitments.

The Individual Rating of **B** indicates a strong institution with no major operational concerns, strong profitability, and a high level of balance sheet integrity.

The Support Rating of **2** indicates a high probability of external support from a credible third party e.g. Government or highly rated parent organisation

- There is a **£5 million limit** on total deposits with any individual organisation.

- There is currently no explicit limit on maximum loan periods, but in practice very few investments are made beyond 1 year (at 31 December 2008 £5 million out of a total of £54 million matures beyond 1 year's time). The policy relating to loan periods requires clarification.
- When compared to other London Boroughs, there are 2 very striking features relating to the LBWF strategy: firstly the strategy is comparatively straight-forward and secondly it is very stringent.
- In contrast, a number of London Boroughs employ quite complex matrix based combinations of ratings/ maximum limits/ and investment periods to determine their strategy. At the other extreme, a number of Authorities rely solely on their external Treasury Advisors' approved counterparty listings.
- The stringency of the LBWF strategy is particularly pronounced in relation to its £5 million investment limit. Of the 23 London Boroughs which responded to the recent Society of London Treasurers' survey, none applied an upper limit of £5 million for all categories of counterparties.
- Maximum limits for the highest rated institutions are in some instances significantly above this level, e.g. Westminster has set a £75 million upper limit for main UK clearing banks, with minimum AA Long term and F1+ Short term ratings; Wandsworth has set a £40 million upper limit for similar ratings; whilst Southwark also applies a £40 million limit for its most highly rated counterparties.
- It should however be recognised that the average level of cash deposits for these Authorities is currently significantly higher than those of Waltham Forest. Nevertheless Waltham Forest's £5 million limit was first introduced in 1991, and it is, therefore, appropriate to consider increasing the limit for the most highly rated financial institutions.
- The comparative simplicity and stringency of the LBWF strategy is in many ways a positive feature, particularly in the current financial climate, but consideration needs to be given as to whether, by adopting a more ambitious and flexible approach, it may be possible to enhance the Council's cash investment options and, at the same time, secure improvements in the security of deposits.
- Following the recent events in the banking sector, most London Authorities are in the process of reviewing their investment strategies. One common theme is to consider channelling investments into the perceived safe haven of UK based institutions, which are protected by comprehensive Government guarantees. The London Borough of Waltham Forest, therefore, needs to consider whether the Council's

overall risks may be reduced by diverting a greater proportion of investments into UK institutions.

Recommended Revised Investment Strategy

- It should be recognised that the current stringent uncomplicated approach would appear to have served the Council well to date. The proposals for consideration, therefore, seek to build on the existing structure, rather than replace it totally. The underlying objective is to enhance the Council's cash investment options, whilst improving the fundamental security of deposits.
- **A 5-Tier approach, largely based on Fitch ratings is proposed, as follows:**
- **TIER 1 based on UK institutions** with minimum Fitch ratings

Long Term AA- , Short Term F1+, Individual B, Support 1

The suggested Tier 1 maximum deposit limit is **£10 million**

The suggested Tier 1 maximum investment period is **1 year ***

*(Up to **2 years** if explicitly agreed by Director of Finance)

It is also recommended that a **limit should be placed on deposits exceeding 1 year**, equivalent to 20 per cent of total sums invested.

Tier 1 includes the institutions that were specifically included in the recent Government recapitalisation scheme e.g. HBOS, Abbey, HSBC, Barclays, Lloyds/TSB, and Nationwide BS. It should also be noted that these institutions have the maximum short term and support ratings, combined with a very strong long term rating.

The increased deposit limit to £10 million for Tier 1 reflects the aim of trying to increase the availability and security of cash investment options by raising the concentration of cash deposited with the most highly rated UK institutions.

A comprehensive listing of current Tier 1 institutions is included in Appendix C.

- **TIER 2 based on UK institutions** with minimum Fitch ratings

Long Term A, Short Term F1+, Individual B/C, Support 1

The suggested Tier 2 maximum deposit limit is **£5 million**.

The suggested Tier 2 maximum investment period is **6 months***

*(Up to **1 year** if explicitly agreed by Director of Finance)

The individual criteria for Tier 2 is marginally lower than our existing minimum requirement. This will in most cases reflect concerns over short term profitability in the current financial climate. As far as security of investments is concerned, this negative aspect should be more than offset by the maximum short term and support criteria attached to TIER 2.

A comprehensive listing of current Tier 2 institutions is included in Appendix C

- **TIER 3 based on current minimum Fitch ratings**

Long Term A, Short Term F2, Individual B, Support 2

The suggested Tier 3 maximum deposit limit is unchanged at **£5 million**. The suggested Tier 3 maximum investment period is **3 months***

*(Up to **6 months** if explicitly agreed by Director of Finance)

Tier 3 reflects The Council's existing criteria. It is recommended that this category should be retained with an unchanged limit of £5 million, but in order to minimise the risks relating to the fact that many of the Tier 3 banks are based overseas and therefore do not receive the same level of national support as UK banks, it is suggested that the maximum investment period should be limited to periods of 3 - 6 months.

Tier 3 includes a large number of UK and Overseas institutions
A sample listing of current Tier 3 banks is included in Appendix C

TIER 4 Overnight Deposits with the Co-op Bank

Currently, the Council may make overnight deposits with its own banker the **Co-op**. Although the rates are comparatively low, this provides a useful, accessible, low-risk facility in an emergency, or when market conditions are difficult.

It is recommended that the Tier 4, overnight deposit limit with the Co-op Bank should be set at **£15 million ***

*(**£20 million** if explicitly agreed by Director of Finance)

It is anticipated that substantial overnight deposits would only be placed in an emergency, or other exceptional circumstances. The £15 million to £20 million limit reflects the maximum future estimated daily cash balance, based on current cash flow forecasts.

- **TIER 5 Direct Lending to the UK Government**

Lending to the **UK Government** direct through the **Debt Management Office** (DMADF). This is a very low risk option, but it is reflected in comparatively low interest rates. Nevertheless, this could be another useful facility in an emergency. It is, therefore, recommended that Tier 5 lending to the UK Government should be approved up to an upper limit of **£25 million** over a maximum of **6 months**, (12 months with the explicit agreement of the Director of Finance) subject to the UK retaining its current Sovereignty rating of **AAA**. The £25 million limit equates to roughly 50 per cent of the Council's estimated average balance of cash on deposit during 2009/10.

- **Other Possible Options**

a) Building Societies are very active in the Local Authority Market, but under our current criteria the Council is at present only able to deposit cash with Nationwide. London Councils are planning to lobby the Government to guarantee Local Authority deposits with Building Societies. Any explicit guarantee could be sufficient to justify lending to a greater range of Building Societies. Alternatively, improved support ratings arising from Government guarantees may enable them to be considered under our current **Tier 3** category above.

b) The Council does not currently deposit with other **Local Authorities**, because they are not covered by our rating criteria. The London Borough of Harrow has suggested that the Society of London Treasurers (SLT) should consider initiating arrangements to encourage the re-introduction of inter - Authority lending/borrowing .This may be worth supporting, as it could provide an additional low risk short term investment option.

c) Other Government instruments, for example gilts. In the present climate this is again a very safe option, but the returns are currently comparatively low, due to an exceptionally high demand for gilts relative to their supply. At present it is suggested that cash deposits with the DMADF are probably equally secure, and currently offer a better return.

This situation could, however change dramatically over the next few years, following the recent announcement of plans to significantly increase the level of Government borrowing. It is likely that this will to a large extent be achieved by a substantial expansion of gilt issues, which may require significant increases on investment returns.

d) It is, therefore, recommended that developments relating to these other potential investment opportunities be kept under review, with the possibility of adding them to the Council's approved investment options, at an appropriate stage in the future.

- **Overall Recommendations**

- a) To adopt the proposed 5 TIER investment strategy as described above.
- b) To keep other options, for example Building Societies, other Local Authorities, and UK Government Instruments under review, with the possibility of adding further investment tiers during the year.
- c) In view of the continuing problems in placing cash deposits with suitably rated institutions, at an appropriate rate of interest it is recommended that the 5 tier strategy should be adopted with immediate effect – that is as from the week beginning Monday **2 March 2009**.