Investment / Counterparty Issues

2007 was unprecedented in terms of money market activity. Starting with the surprise Bank of England rate hike in January and ending with a full blown credit crunch the like of which has never been witnessed. Circumstances such as these make all investors re-evaluate their methodology and systems and Local Authorities should be no different.

We examine below two key aspects of investment - counterparty risk and investment methodology. These are central to client investment strategies for the coming year(s). We outline our present thinking on how clients should approach them, given what has happened in 2007 and what our assumptions are for 2008 and beyond. The key points and our recommendations are summarised below:

- The premium seen in money market rates in the second half of 2007 will likely continue into 2008. Key to this might be the financial institution results due in late February.
- The yield spread between investments offered by differently rated institutions has also widened – a clear indication that risk appreciation has resumed a much greater role in market activity. This will also continue through 2008.
- The basic tenets of Local Authority Investment Guidance are Security 1st, Liquidity 2nd and Yield, although important, 3rd.
- Clients may need to adjust their strategies to further reflect this.
- Adopting a lowest common denominator approach to choosing counterparties and applying relevant limits is important.
- Consider restricting investments in “A” rated organisations to just one year.
- Consider widening the gap between money limits offered to unrated/lower rated organisations and those with stronger ratings (long term AA- or better).
- Analysis of cash flow and balance sheet will help to focus on the nature of investment funds.
- Look to use AAA-rated Money Market Funds – security and liquidity are excellent and yields are now much improved versus other short term investments such as bank call accounts.
- Longer-dated Money Market Funds could also be used alongside term deposits for periods out to one year.
- Investments beyond one year have evolved markedly in recent years. However, interest rate as well as default risk needs to be considered.
- Alternative forms of investment via external fund managers may also prove to be attractive.

Counterparty Risk

Background

Events in the latter stages of 2007 saw a significant re-pricing of risk. The most obvious example of was the massive widening in the gap between money market rates and official rates. The following table charts the movement of the spread (3m LIBOR less Bank Rate) through the year:

Period	Average Spread
January – August 2007	34bps
August	67bps
September	90bps
October	52bps
November	66bps
December (to 7th)	98bps

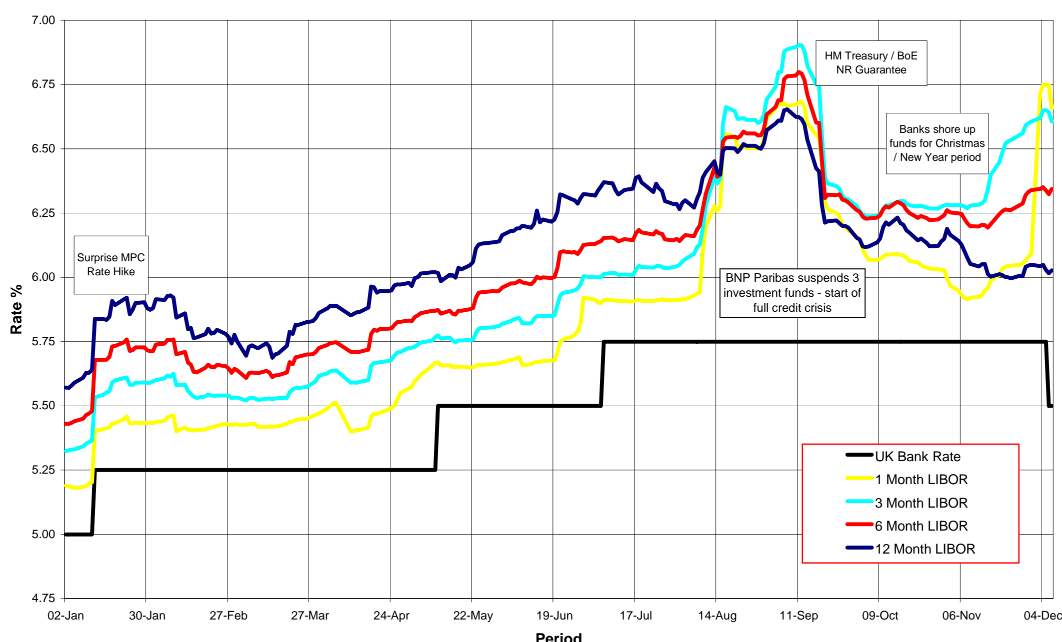
The upward spike in December was partly a result of the cut in Bank Rate by the Monetary Policy Committee, but the level was already at 90bps before the MPC moved. Investors were desperate for cash to tide them over the Christmas and New Year period and this great need hit rates for periods of one to three-months hard.

The major question is what will occur in 2008? Will the wide margin in short dates continue and if so, for how long? The key to this may well lie in the 2007 results for financial institutions - both UK and overseas - due in late February. Until such time, market mistrust will almost certainly ensure a significant premium on short dated money rates.

The mistrust stems from two fundamental problems. The first is concern over direct/indirect exposure to US subprime debt and the second is concern over the wider impact of the credit crunch.

The extent of any exposure of UK organisations to US subprime debt is small when compared with overall assets. It therefore follows that the likelihood of defaults occurring purely because of this is low. Investors in marketable securities (such as corporate bonds) are more concerned because the prices of the assets they hold can rise and fall. Organisations tainted by US subprime debt exposure have seen their securities fall in value and this has led to underperformance.

The impact of the credit crunch is much more widespread and potentially much more damaging. We have seen this already in terms of Northern Rock whose future is still uncertain. The credit crunch itself has two main strands. First, is the general distrust which is making counterparties reluctant to trade with each other. The second is that major banks who have issued guarantees/credit lines to structured investment vehicles (SIVs) are hoarding cash in case these are called upon. This twin effect has seen a marked tightening of liquidity and a steep increase in money market rates in the second half of 2007, as seen in the chart below.



The chart shows that sterling money rates did ease back following the issuance of the HM Treasury guarantee for Northern Rock. Rates were also helped by the Bank of England reiterating that its role of Lender of Last Resort was open to other organisations that were facing similar short term liquidity difficulties. Injections of cash into money markets by the European Central Bank and US Federal Reserve also dampened yields. However, for sterling rates out to 3 months, the easing proved short-lived. These rates surged higher on the back of the need for counterparties to secure funds over the Christmas and New Year period – when funds are traditionally scarce.

The other, perhaps less noticeable impact, has been the widening of the spread between investment rates offered by “A” and “AA” (or better) organisations. In the 12 month area the highest rates (c.6.20%) are coming from “A” rated small banks or building societies while rates from “AA” names for similar amounts have remained below 6%. This is a clear indication that risk appreciation has heightened. Although we expect the liquidity premium in market rates to evaporate during 2008, this risk-related wider nature of the spread will almost certainly continue.

The Future

If this spread is to remain in place, what does it mean in terms of Local authority investment? First and foremost, it needs to be said that there has always been risk attached to any investment, it is just the case that the appreciation, indeed understanding, of this risk has been muted in recent years.

It must also be understood that Councils’ counterparty criteria only allows them to deal with a relatively small number of highly rated institutions - typically around 100. To put this in context, Fitch rates around 3,500 financial organisations, Moody’s and Standard & Poors around 12,000 corporate issuers (including financial organisations).

In the main, Local Authorities investments are directed to fixed term deposits, or some derivation thereof. As such, the biggest risk is that of default, rather than a change in price as with marketable securities. The credit crunch has heightened the chance of a default, but the nature and strength of counterparties that Councils can deal with significantly reduces the chance of them being affected.

The following table from Moody's provides a history of the default rates of corporate issuers (including financial organisations) for the period 1982 – 2005 on investments out to 5 years. This reaffirms our view that the statures of the organisations used by councils are such that the likelihood of a substantial loss through their use, although not nil, is remote. There is always risk with any investment, but the robust Strategy employed by Councils reduces this to, what we would deem, acceptable levels.

			(Percent)		
Cohort Rating	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Aaa	0.000	0.000	0.000	0.000	0.004
Aa	0.000	0.001	0.018	0.038	0.080
A	0.007	0.033	0.090	0.159	0.227
Baa	0.108	0.313	0.572	0.902	1.241
Ba	0.767	2.173	3.925	5.623	7.042
B	3.605	8.059	12.119	15.590	18.612
Caa-C	14.427	22.966	29.530	34.112	37.701
Investment Grade	0.041	0.111	0.257	0.470	0.766
Speculative Grade	3.246	6.709	13.019	18.903	26.965
All Corporates	1.078	0.445	2.475	4.358	6.974

Nevertheless, there are still actions that can and should be taken to minimise risk further.

The first of these is to adopt a Lowest Common Denominator (LCD) approach to both choosing counterparties and applying limits to them. Traditionally, Local Authorities have either relied on just one credit rating agency, or used a counterparty whose limits from one agency have met their minimum requirements.

Up to 2007, this approach did not present a significant issue as the three major rating agencies differed little in the level of ratings they applied to organisations. However, following the introduction of the Moody's Joint Default Analysis (completed May 2007) the spread between ratings from each agency has widened. This is shown in the following table which compares similarly defined ratings (with each rating level equating to 1pt) from each of the three rating agencies we use:

	Short Term			Long Term			Individual / FSR
	Fitch - Moody's	S&P - Moody's	Fitch - S&P	Fitch - Moody's	S&P - Moody's	Fitch - S&P	Fitch - Moody's
Old Ratings	-0.12	-0.38	0.20	-0.15	-0.53	0.27	0.44
New Ratings	-0.19	-0.40	0.19	-1.17	-1.57	0.23	0.70
Change	0.07	0.03	0.01	1.01	1.04	0.04	-0.26

This greater spread in ratings was caused by a change in Moody's rating methodology rather than a change in organisations affected. As such, clients using the traditional method of counterparty selection and limit application may have found new organisations added to their list, or limits raised without the counterparties themselves showing any improvement.

The LCD method would negate these potential Moody's-related changes by only using or applying appropriate limits to counterparties where all their ratings meet a particular level, not just those from one agency.

The other major reason for switching to an LCD approach is risk assessment. Ratings are a statement of opinion and not a guarantee. There will, therefore, be some differences in opinion between the agencies over organisations. This may be due to fundamental reasons or merely because a recent detailed assessment by one agency may lead to it changing ratings ahead of moves by other agencies. Added to this is the current turmoil which is affecting financial institutions. The credit crunch has reaffirmed the need to adhere to the basic tenets of Local authority investment which are Security first, Liquidity second and Yield third. The use of an LCD approach will reinforce a council's risk appreciation.

The second area to consider is which counterparties clients should contemplate using when investing for periods beyond one year. Until now, most clients with this ability have used institutions with a minimum long term rating of "A-". In August we suggested that clients should restrict investments to just short term periods. We have relaxed our position on this as more details on counterparty situations have emerged. We now recommend that clients can invest for beyond one year, but should only do so with institutions that have a long term rating of "AA-" or better. We appreciate that this will restrict the number of counterparties that can be dealt with. However, given the current financial uncertainty, coupled with the prime local authority investment criteria of security, we believe that this is the most appropriate strategy. We will continue to review circumstances and inform clients if we believe it is appropriate to relax this strategy.

There are two approaches to adopting such a strategy. This first is formally through the Annual Investment Strategy and the second is informally through day-to-day practice. In the future we will likely lower the limit back to minimum "A-" rating. If clients make a formal change to their Strategy then they will need to go back to Full Council to get this reversed. However, if they just use the limit on an informal basis, then no return to Full Council will be needed.

The third aspect of counterparty risk to review is monetary limits. Clients usually assign higher limits to better rated organisations. We would suggest that under the current circumstances the spread between limits for different strength counterparties is widened. This can be achieved by lowering limits for unrated or "A" rated institutions and raising those for "AA" counterparties. Security is and always will be the primary concern for investing and the change is designed to reinforce this tenet in overall strategies. Evidently, access to large, highly rated organisations is often restricted in terms of deal size. However, investments such as call accounts and callable deposits, as opposed to traditional term deposits with certain "AA" institutions, do provide some access. The other benefit of introducing this change is that it will ensure greater spread of funds among different institutions, especially with unrated or "A" rated counterparties. The credit crunch has seen a number of building societies return to using money markets for funds as opposed to direct lending or borrowing in the capital markets. This increase in the number of useable counterparties should alleviate any major difficulties with placing funds in the money market in the months ahead, especially when the amount of money available is reduced by natural cash flow run-down. The use of Money Market Funds which offer high security, liquidity and now yield will also lessen difficulties.

These are the main issues that need to address at the present time. However, if you have individual concerns then please do not hesitate to contact me.

Investment Methodology

The recommendations and advice given on counterparty risk have a part to play in how Local authority funds are invested. The increased level of risk assessment does have a downside in terms of potential overall return. As a result, we need to address how funds are invested to ensure that the best performance can be achieved.

The starting point is the nature of the cash balances, looking from the perspective of liquidity, cash flow and core funds. An analysis of the balance sheet will assist in identifying the make up of the cash balances at year end. A medium term cash flow can be compiled using the information identified in the analysis of the balance sheet. In broad terms, this should assist the Council in looking at the longevity of the cash balances.

Ideally the Council should be looking to split the cash balances into the following:

- Liquid funds – those cash balances required for day to day cash flow requirements
- Cash flow – those funds that can be invested up to 364 days
- Core funds – those funds that are not required in the short term and can be invested strategically

The Council's historical daily cash flow records will assist in identifying how much cash the Council needs to keep liquid. The records will show the fluctuations in daily cash balances and the highs will form the level of balances required for liquidity purposes.

The analysis of the balance sheet will identify reserves and balances that make up the cash balances. Profiling the reserves and balances (Medium Term Financial Strategy will assist in this) will identify cash balances that are available longer term – core funds.

The cash balances required for cash flow purposes will be the difference between core funds and liquidity funds.

Due to the nature of forecasting cash balances the Council should err on the side of caution, this means it should build in a level of comfort when setting its levels.

Using this analysis we suggest that clients should be able to approximately split their funds into three different pools:

Pool 1 - Liquidity

The first pool will be funds where liquidity is the foremost concern. Clients will often keep some portion of their funds invested on a short term basis through the markets or by using call account funds operated by large banks. When conducting this type of investment in the future we would recommend clients look at the alternative of using Money Market Funds. Since their permission for English and Welsh authorities in 2002, many clients have shied away from their use on grounds of lacklustre performance. However, in the circumstances likely to prevail in 2008, the performance could well be much better than that available in bank, rate-related call accounts. The nature of the funds has allowed them to benefit from the high rates of

return available in money markets and this, allied to their inherent security (AAA rated) and liquidity, make them an attractive proposition.

We have been in discussion with a company within the ICAP group that has created an online system for trading in these AAA-rated funds. The system (www.mytreasury.com) is due for formal launch in February 2008 and will provide clients with direct access to all the major fund providers. The system has other significant advantages: minimum transaction sizes are much reduced; trade administration is automated; access to data on the performance of all participating managers (the vast majority of major names) is available. Transparency and ease of access allow clients to make more informed decisions as to which funds best suit their needs.

The use of Money Market Funds in place of individual bank deposits will provide two further enhancements. First, it will increase the overall credit strength of portfolios. Second, sweeping surplus funds into these pooled vehicles will free-up the availability of other counterparties for investment over other periods.

Pool 2 – Cash Flow

The second part of investment methodology concerns funds which are available for investment for up to one year. Their longer-term nature will likely mean that in normal circumstances the use of those instrument types outlined above will not be appropriate. As such, the bulk of these investments will be made via simple fixed term deposits.

We have discussed the Local authority requirement with a number of external fund managers to see what options they might be able to provide. The primary focus was once again trying to improve overall security of funds. The following summarises the responses.

One manager suggested that it could provide a Certificate of Deposit (CD) pool which would be restricted to exposure to only the highest rated (F1+ or equivalent) counterparties. The benefit in terms of counterparty risk would be sizeable for some authorities. However, it did suggest that for such a pool to be viable a sizeable level of funds would be required. Given the variations in the amount of cash local authorities have at different stages of the year, maintenance of an investment pool of acceptable size may prove difficult.

Another manager suggested that a number of (neighbouring) authorities might consider pooling resources in order to deal in sizes large enough to attract offers from higher rated counterparties. However, the logistics of this and the legal requirements could well make this impractical.

Other managers suggested that pooled investment products they already manage could be suitable for this type of money. The products are similar to Money Market Funds but, rather than targeting a short-dated benchmark such as overnight or the 7 day rate, they are benchmarked against 1 or 3 month LIBOR. The longer-term nature of the funds would make them more suitable for this type of money and, like MMF liquidity funds, their use would enhance the overall security of investments. Their use as part of a number of investments would also help reduce the problems that could arise from the adoption of reduced limits for lower-rated counterparties.

Of all the suggestions, we believe that the MMF option is the most suitable. These would not be a direct replacement for all investments of a cash flow nature. Instead, they would form part of the overall balanced investment approach.

One issue that needs to be addressed is valuation. The funds have an "accumulating" status rather than being quoted with a stable net asset value (as with the standard high liquidity MMFs). This means that, rather than the value of each unit remaining at £1 and all returns being distributed, income and any movement in capital value is reflected in the price of each unit. The potential problem is that any movement in price is deemed to be unrealised until the asset is sold. The SoRP 2007 states that any unrealised gains (or losses) have to be held on the balance sheet until they are realised rather than being taken straight to the I&E account at year end. One possible solution is to sell the units ahead of year end. However, this is not ideal and it is hoped that, as with other accounting issues arising from SoRP 2007 the difficulty will be resolved in due course.

Pool 3 – Long Term Investing

The final part of the investment portfolio is for those funds available for investment beyond one year. In the past, external fund managers were employed to invest this type of money. However, poor performances in recent years have reduced their attractiveness and this, along with the sharp increase in long-term deposit rates to seemingly attractive levels, encouraged many Councils to take funds back in-house and invest them through money markets.

Long term money market investments have evolved substantially in recent years. The main change has been the increased use of callable deposits in their various different guises. The major attraction of these is the ability to invest with large "AA" rated organisations in sizes from as little as £3m. Performance of many of these types of deposit has also been attractive, especially when compared with standard deposits of a similar length.

These types of deposit will likely to evolve further to meet the changing demands of Local Authorities. However, clients need to be fully aware of the potential interest rate risk associated with some of these products. Exotic structures that seem to offer high returns will often have provisions attached to them, which if exercised, could severely undermine performance. Although the primary concern, risk of default is not the only issue that needs to be taken into account when investing.

One of the principal problems for external fund managers in recent years is that their segregated approach only really allowed them to outperform a short-dated cash benchmark when yields were falling. Unfortunately in recent times market yields were either flat or rising. This meant the ability for any local authority external fund manager to outperform a cash benchmark was limited.

The managers have approached this issue by looking at alternative methods for investing. The prime route they are now looking to use is pooled investment vehicles. Changes to UCITS (Undertakings for Collective Investment in Transferable Securities) regulation in early 2007 have allowed these funds to "go "short" of markets. They can now take positions that are designed to enhance returns in an environment where yields are rising (prices are falling). In theory, these funds should be able to produce above-cash returns in all market environments, a significant advantage over the traditional method of investing.

However, these funds are in their infancy and without a track record behind them it is difficult unreservedly to recommend their use by clients. In time, assuming they achieve their expected returns, they will likely become a favourable avenue for investment. At the present this is not the case.

Conclusion

We do appreciate that some of the changes outlined above will not be suitable for all clients. Nevertheless, the general theme of risk minimisation has to be central to all investment strategies. Current market uncertainty has made this even more important. Some of the changes will obviously restrict investment activity but others should help to lessen any practical difficulties.

Yield is important and something that Members and Officers will almost exclusively focus upon. However, it has to come with a commensurate and manageable level of risk. 2007 has not suddenly made all financial institutions less safe for investments, but it has been a stark reminder that there is no such thing as a risk free investment. International markets are responding to this and we firmly believe that our clients should do likewise.

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