ITEM NO: 5

BRENT COUNCIL	**Audit Committee** 17th December 2008 **Report from the Director of Finance and Corporate Resources**
For Action	Wards Affected: ALL
Report Title:	**Deposits with Icelandic Banks**

1. SUMMARY

1.1 I have previously reported to the Budget Panel on budget issues arising from the two loans to Icelandic banks, and to the Performance and Finance Select Committee on the monitoring of investments. This report details internal controls on lending to other institutions, the response to the problems with Icelandic banks, and proposals to improve member scrutiny and training.

2. RECOMMENDATIONS

2.1 Members are asked to comment on internal controls on lending, and the proposals to improve scrutiny of the Council's investment strategy (para. 3.6.1) and training (para. 3.6 .2).

3 DETAIL

3.1 Current Position

3.1.1 Brent Council has two deposits outstanding with Icelandic Banks, as follows:-

Heritable Bank	£10m	5.85%	Lent 15.08.08	Due back 14.11.08
Glitnir Bank	£5m	5.85%	Lent 15.09.08	Due back 12.12.08

The deposits were made at 'good' rates, but not rates that were wildly out of line with the rest of the market. Both of the banks are now in administration. Heritable Bank, a subsidiary of the Icelandic bank Landsbanki, is largely a UK bank, and its UK assets are being administered by Ernst and Young. The £10m deposit was **not** returned on 14th November. Glitnir is being administered by the Icelandic equivalent of the Financial Services Authority. Other local authorities (total 120, owed approximately £859m) have also invested in Icelandic banks, as has the Audit Commission, charities and others.

3.1.2 Brent is working with other local authorities, the Local Government Association (LGA) and other organisations such as the Chartered Institute of Public Finance and Accountancy (CIPFA) to recover the two loans or to mitigate the effects of non-recovery until the situation is resolved, as follows:-

a) Register the two debts so that Brent will be considered as a creditor.
b) Share information on the debts and treasury management with other local authorities.
c) Support the LGA as it lobbies government departments, ministers and other organisations such as the Audit Commission and CIPFA. As part of this effort, a number of local authorities have been selected as lead creditors to discuss / argue issues with administrators – in particular, the London Borough of Barnet and Kent County Council, with legal support, have taken part in discussions in Iceland.
d) Council's are examining ways to put further pressure on the government and the Treasury to support councils in the recovery of their deposits. It is understood that the government, working with European partners, has sought further assurances from Iceland before an International Monetary Fund loan was agreed.
e) The Department for Communities and Local Government (DCLG) has recognised that it will take some time to resolve the Icelandic loans issue, and has issued guidance that will remove uncertainty over the preparation of budgets for 2009/10. The DCLG will allow councils to exclude possible losses from their investments in Icelandic banks from their 2009/10 budgets, so that the impact of any impairment is postponed to 2010-11.

3.2 Lending procedures

3.2.1 Under the 1996 CIPFA Code of Practice on Treasury Management in Local Authorities, treasury management was defined as 'the management of the local authority's cash flow, its borrowings and its investments, the management of the associated risks and the pursuit of the optimum performance or return consistent with those risks.' The protection of the council's cash balances was seen as more important than the pursuit of additional marginal returns.

3.2.2 The Code of Practice was revised in 2002. The council was required to:-

a) Adopt the Code by passing four clauses. These confirmed, first, that the Council would adopt the recommendations from the Code. Second, that it would maintain a treasury management policy statement and treasury management practices. Third, that the Council would receive reports on the annual treasury strategy and plan in advance of the year, and an annual report after its close. Fourth, that the Council delegated responsibility for the implementation and monitoring of its treasury management policies and practices to the Executive, and for the execution and administration of treasury management decisions to the Director of Finance.
b) Prepare a brief treasury management policy statement (Appendix 1) stating the policies and objectives of its treasury management activities. This is a 'broad' document, but reiterates that the 'identification, monitoring and control of risk is a prime criterion by which the effectiveness of treasury management activities will be measured'. This links with the Prudential Code for Local Government, which seeks to ensure that financial issues are managed with regard to risk as well as return.
c) Prepare up to twelve treasury management practices (TMPs), setting out the manner in which the organisation will seek to achieve its policies and objectives, and describing how it will manage and control those activities. The detailed practices cover :- Treasury risk management; best value and performance management; decision making and analysis; approved instruments, methods and techniques; organisation, clarity and segregation of responsibilities, and dealing arrangements; reporting requirements and management information arrangements; budgeting, accounting and audit arrangements; cash and cash flow management; money laundering; staff training and qualifications; use of external service providers; and corporate governance.

3.2.3 As set out in paragraph 3.2.3 c), the TMPs set out in detail how treasury management activities will be managed and controlled. A typical day might be:-

a) Dealer looks at expected activity for the day entered in the diary – loans / borrowings maturing, grants being received, income expected, major / regular payments. Consider projected cash flow over the next few weeks / months.
b) Runs daily balances from bankline system that links to the Council's account at National Westminster bank.
c) Calculates borrowing / lending requirement.
d) Obtains and compares rates from a number of brokers. Ascertains optimum borrowing / lending maturity. Either deals through a broker using the authorised lending list (see 3.2.4), of which the brokers also have sight, or through one of the money market funds used by Brent.
e) If using a broker, obtains confirmation of the deal, rates and settlement instructions. Checks that these are correct.
f) Enters settlement details into bankline system.
g) Details are checked by two independent authorisers – officers who do not deal but are trained to check borrowing and lending details (calculations, bank details) and letters to lenders / borrowers. The authorisers will have access to details of overall loans and borrowing outstanding. Authorisers agree bankline details on line.
h) Dealer sends the data to Natwest via bankline for payment.

3.2.4 A key part of the Treasury Management lending strategy is the lending list agreed by the Director of Finance. The list had been developed over a long period of time, and was constructed on the bases of the control of risk (using credit ratings to assess the credit worthiness of financial institutions – see Appendix 2) and the spreading of risk (maximum amounts that can be lent to particular institutions). Brent used four individual credit ratings (where available) to construct a high quality list, placing particular emphasis on the short term rating in both UK and overseas, and including the support rating overseas. The list was constructed in consultation with our Treasury Adviser, currently Butlers, previously Sector (changed Spring 2007). The lending list was fully reviewed in 2006 (see Appendix 6). Until recently, the Council made deposits with UK and overseas banks, building societies, international organisations that have clear government support, highly rated money market funds, and central and local authorities.

3.2.5 Appendix 3 sets out Butler's role as treasury adviser. It will be seen that the house gives advice on a range of treasury issues – interest rate forecasts, debt restructuring, lending lists, changes to accounting requirements, borrowing, and overall treasury strategy. They supply and monitor credit ratings prepared by the various agencies, emailing changes that may affect Brent. Butlers are in regular contact, giving advice and relevant information. The current cost of the contract is £20,000 per annum.

3.2.6 In 1998, members agreed to the appointment of two external treasury managers managing £20m each, who had skills to use a wider range of investment instruments than could be accessed by the in-house team, thereby spreading risk. In particular, the managers could use certificates of deposit (short term investment grade loans to companies of appropriate financial standing, tradeable on the financial markets) and government gilts (longer term financial instruments issued by the UK government to finance capital and other expenditure). It was expected that the external managers would be able to use their skills to gain higher returns than the in-house team. Aberdeen Asset Management was appointed in 1998 and has retained the mandate, but the other mandate was terminated in 2007 when the incumbent manager decided to exit the market. Aberdeen Asset Management uses the Brent lending list but also cross-references to an in-house list.

3.2.7 Treasury activity is subject to scrutiny by both internal and external audit. The internal auditors examined lending processes in 2007 and gave a ‘Satisfactory assurance’ rating – that there was a sound system with some weaknesses. These have since been addressed. Our external auditor, the Audit Commission, also reviews treasury activity, but mainly to confirm end of year details. It is planned that internal audit will review treasury activity – in particular the lending system – early in 2009. The Audit Commission has commenced a review of treasury management in local authorities, including Brent, examining lending generally and to Icelandic banks specifically. A report will be issued in due course that will highlight best practice across the country.

3.3 Reporting

3.3.1 In addition to the two annual and occasional reports to members when specific issues arise (such as the introduction of the Prudential Code), and regular oral communication with senior management on interest rate and market developments, the treasury team prepares a weekly report to the Deputy Director of Finance detailing both treasury and prudential information:-

a) The value of deposits with other institutions.
b) The value of deposits for more than one year (limit currently £60m).
c) Projected average interest rate on deposits for the financial year (to be compared with budget).
d) Maturity of deposits – how much will mature in a week, month, three months etc.
e) Cash flow information – how much is expected to be lent at the end of next week or next month.

3.4 Actions taken as the credit crisis unfolded

3.4.1 Following a number of takeovers (often forced) and support operations by central banks, on 30th September the Director of Finance amended the Brent lending list to exclude the second tier of UK banks (including Heritable) and the third and fourth tiers of overseas banks (including Glitnir), and to consider exposure to building societies. On 8th October, following the collapse of the Icelandic banks, the list was amended again (see Appendix 4) to:-

a) exclude all overseas banks,
b) reduce the amounts that could be lent to financial institutions apart from money market funds,
c) reduce the maturity of deposits to three months,
d) amend the authorisation procedures for building societies so that loans can only be made after agreement by senior management.

3.5 Lending List – Options under consideration

3.5.1 The capital financing budget is a major area of expenditure and income. The council will pay an average rate of 4.95% in 2008/09 on its borrowings, down from 6.29% in 2005/06 following major debt restructuring. The details for lending are as follows:-

	Interest received	Average rate
	£m	%
2006/07	5.0	4.7
2007/08	6.2	5.3
2008/09 (expected)	6.1	5.5
2009/10 (draft budget)	3.0	3.5

The value of the interest earned is dependent on a number of factors, mainly interest rates but also opportunities to lend short or long term, and the breadth of the lending list itself. Loans outstanding as at 24th November are listed in Appendix 5. It will be seen that various loans were made for long maturities to prepare for falling interest rates. It should also be noted that, when the lending list was reviewed in 2006, the option to weaken credit quality to enhance interest receipts was rejected because the risks were too great. However, having a fairly sizeable list that includes overseas banks and does not rely on clearing banks that only borrow in large amounts, has been important.

3.5.2 To place paragraph 3.5.1 in context, Brent could lend all its balances to the Debt Management Office, a government organisation - and supposedly 100% secure - that funds long term borrowing to councils (via the Public Works Loans Board) and others. The rate received is usually set around 2.5% below bank rate. On the basis that Brent currently earns just above bank rate on deposits, the loss in interest received would be around £2.5m - £3m per annum in a normal year. It is therefore important that the lending list be sufficiently broad and should minimise – but not remove – risk.

3.5.3 A number of options are being considered and discussed with Butlers, for possible implementation after the current banking and credit crises have eased, as follows:-

a) How Brent should use credit ratings in future, and which markets should be considered. It should be noted that, apart from for Icelandic banks which were affected by a national issue, the credit ratings did their job. For example, although HBOS was close to collapse, government support was forthcoming to prevent any default. Again, Fortis bank in Belgium was threatended by liquidity issues – it could not borrow on the wholesale inter-bank market. The Belgian authorities realised that Belgium alone had insufficient resources to support the bank, and obtained help from neighbouring countries.
b) Some countries, such as Ireland and Singapore, have issued guarantees to various of their banks. Once it is clear exactly what is being guaranteed, various banks could return to the lending list.
c) Whether or not there are other indicators that may help identify problems. It is apparent that some authorities and commentators had identified problems with the Icelandic economy and Icelandic banking. It may be that either sovereign ratings – that will look at individual countries – or credit default swaps, that may indicate market concerns about a bank, may help. However, the credit rating agencies had access to credit default information and did not forecast a default.
d) Whether or not there is need to reduce the size of deposits with some building societies, or to limit exposure to the sector. Although no building society has ever been allowed to fail, and the sector is very tightly regulated, it may be prudent to spread risk.

3.6 **Management Information and Training for Members**

3.6.1 It is suggested that the following management information on lending may be useful to members:-

a) Discussion of the credit rating and other criteria that are used to compose the lending list, and any changes to that criteria.
b) Prudential indicator for lending – the value of loans of more than one year duration (limit currently £60m).
c) A quarterly report listing loans outstanding at the end of the period. This will indicate in which sectors the financial institutions are (UK banks, overseas banks, building societies etc) and the duration of the portfolio. It will include details for the external manager.

3.6.2 It is proposed that a training session/s be arranged for members examining the various aspects of treasury management and the key indicators for members – the items reported in the treasury strategy, as part of the budget, and the treasury outturn. This will cover such items as:-

a) Economic forecasts
b) Lending strategy, including the construction of the lending list. Description of the various debt instruments (cash, certificates of deposit, gilts).
c) Borrowing strategy – both short term for cash flow purposes, and long term from either the market or the Public Works Loans Board to finance capital expenditure. This would include prudential aspects of borrowing, which means not having all the loans due for repayment at the same time, and indicators.
d) Debt restructuring to take advantage of changes in interest rates.
e) Monitoring the external manager / s.
f) The role of the adviser.

4. BACKGROUND INFORMATION

CIPFA – Treasury Management in the Public Services – Code of Practice 2002
Executive report 15th July 2002 – CIPFA Code of Practice – Treasury Management in the Public Sector
Executive report - Budget 2008 – March 2008
Executive report August 2008 – Treasury Management Annual Report 2007/08
Brent Council – Treasury Management Practices
Brent Council – Treasury Policy Statement

Duncan McLeod – Director of Finance
Martin Spriggs – Head of Exchequer and Investment

APPENDIX 1

TREASURY MANAGEMENT POLICY STATEMENT

1 **Brent Council defines its treasury management activities as:-**
'The management of the organisation's cash flows, its banking, money market and capital market transactions: the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks.

2 Brent council regards the successful identification, monitoring and control of risk to be a prime criterion by which the effectiveness of its treasury management activities will be measured. Accordingly, the analysis and reporting of treasury management activities will include their risk implications for the authority. (Note that CIPFA regards the control of risk as 'the' prime criterion by which the effectiveness of treasury management activities will be measured. However, the pursuit of optimum performance is also a prime criterion.)

3 Brent council acknowledges that effective treasury management will provide support towards the achievement of its business and service objectives. It is therefore committed to the principles of achieving best value in treasury management, and to employing suitable performance measurement techniques, within the context of effective risk management.

Appendix 2

Credit ratings

The credit rating agencies (Fitch, Moody's and Standard & Poor) meet with financial institutions, review their financial prospects and issue ratings. The main source of ratings used by Brent is Fitch, which uses four sets of criteria which can be used as an overall grid. This approach should reduce risk, and is followed by a number of other authorities who have also used Sector as their treasury adviser – though some authorities only use two ratings (long term credit and short term credit). The other two rating agencies do not issue support ratings. The Fitch ratings are as follows:-

a) Long term credit ratings are a benchmark of probability of default. The scales are split between investment and speculative grade. Brent only uses investment grade, which is spread from AAA – highest credit quality – to BBB – good credit quality, and then only used A and above.
b) Short term credit ratings are a benchmark of the probability of default, but with a 13 month time horizon. These are usually most relevant to our activity. The scale spreads from F1 (P1 for Moody's) – highest credit quality – to D, which is default. Brent only used F1, or its equivalent, and above.
c) Individual ratings are assigned only to banks and attempt to assess how a bank would be viewed if it were entirely independent and could not rely on external support. The rating looks at soundness of balance sheets and business models. There are often no ratings for subsidiaries. The scale spreads from A, a very strong bank, to F, a bank that has either defaulted or would have defaulted had it not been given support.
d) Support ratings indicate whether or not the bank will receive support should this be necessary. The scale spreads from 1, extremely high probability of external support, to 5, where support cannot be relied upon.

APPENDIX 3

Advisory services provided by Butlers

Butlers was appointed in 2007 following a tender exercise, to provide treasury management services. The company is adviser to around 140 councils, second only in the market to Sector, Brent's adviser until 2006. The services include:-

a) Overview of the Council's financial position, with particular attention given to the balance sheet and to borrowing.
b) Interest rate forecasting and economic advice through updates and newsletters.
c) Debt portfolio advice and monitoring, looking for restructuring opportunities.
d) Advice on borrowing – level of debt, timing of borrowing.
e) Technical advice on all aspects of capital finance arising from legislation or new accounting requirements issued by CIPFA.
f) Investment policy advice and information. This comes in three parts. First, economic and interest rate forecasts. Second, although Butlers do not establish ratings, they undertake a constant review of the ratings supplied by the credit rating agencies that relate to the Brent lending list, with rating changes supplied at once. Third, external fund management performance monitoring.
g) Four strategy review meetings each year.
h) Training and seminars.
i) Leasing advice.

Officers have regular contact with Butlers. While credit rating changes are communicated when they happen, economic and market information is sent on a weekly basis. Officers receive weekly telephone updates on market developments, usually highlighting borrowing opportunities. Until the government lending agency, the Public Works Loans Board (PWLB) changed its discounting rules, there was regular consideration of debt restructuring opportunities.

As said above, Butlers were appointed in 2007 following a review that considered the various market participants. The house replaced Sector, which had lost various key consultants and appeared to be more interested in other consultancy work. Butlers had recruited new consultants before they won the tender – in particular, the consultant who had previously worked with Brent. The team is able, and well resourced, and includes an in house economist / bonds expert, the former head of CIPFA's capital financing division, and a number of experienced consultants.

Since appointment, Butlers have assisted with debt restructurings, long term borrowing, implementation of new CIPFA accounting rules, and a review of the council's balance sheet, as well as giving constant support on lending and economic developments.

APPENDIX 4

Brent treasury lending list (8th October)

UK Banks – up to £10m – rated AA- or above long, F1+ short term, B/C or above individual, 1 support

Abbey National PLC
Alliance & Leicester – linked with Abbey as part of Bank Santander
Bank of Scotland
Barclays Bank PLC
Clydedale Bank
HSBC Bank
Lloyds TSB
National Westminster
Royal Bank of Scotland – linked with Nat West as part of the RBOS group

Building Societies with investment grade ratings – up to £10m – Note that various societies are being taken over by stronger societies.
At present deposits are only made with authorisation from senior management.

Britannia
Chelsea
Cheshire
Coventry
Derbyshire
Dunfermline
Leeds
Nationwide
Newcastle
Norwich & Peterborough
Principality
Scarborough
Skipton
Yorkshire

Money market funds – rated AAA – up to £12m

Royal Bank of Scotland
Gartmore

Local or Government Authorities (up to £12m), including the Debt Management Office – No limit

Supranational Institutions – up to £10m - with AAA long term and F1+ short term ratings, that are supported by major international organisations such as the USA FED or the European Central Bank. These have only ever been used by external managers

APPENDIX 5

The current loans outstanding **as at 24th November** are:

Name	Amount	Yield	Lending	Maturity
£m	**%**	**Date**	**Date**	
Rabobank	5.0	4.95	23.02.06	23/02/09
RBS	5.0	6.25	23.10.06	15/02/09
HBOS	5.0	6.0	16.04.07	16/04/10
HSBC	5.0	5.4	18.04.07	19/04/10
HSBC	5.0	5.85	15.06.07	15/06/10
Cheshire Building Soc	5.0	6.59	30.07.07	30/07/09
Derbyshire BS	5.0	5.96	15.05.08	30/02/09
RBS Global Treas. Fund	11.8	Variable		Call
Gartmore cash reserve	12.0	Variable		Call
Cheshire BS	5.0	5.0	07.05.08	07/05/10
Heritable bank	10.0	5.85	15.08.08	14/11/08
Stroud & Swindon BS	5.0	5.885	15.08.08	29/12/08
Bank of Scotland	5.0	6.2	15.08.08	16/02/09
Glitnir	5.0	5.85	15.09.08	12/12/08
Scarborough BS	5.0	5.68	05.11.08	19.12.08
Dunfermline BS	5.0	5.99	04.02.08	04/02/10
Lloyds TSB	5.0	5.61	15.02.08	15/02/11
Newcastle BS	5.0	6.05	28.04.08	28/04/10
Derbyshire BS	5.0	6.4	16.06.08	16/06/10
Dunfermline BS	5.0	5.9	01.07.08	01/07/10
Skipton BS	5.0	6.48	01.07.08	01/07/11
RBS	5.0	7.0	22.09.08	22/09/11
Total	**128.8**			

Brent has also invested £22.3m with an external manager, Aberdeen Asset Manager, which has placed the fund in a mixture of certificates of deposit (CDs), usually of one year duration but tradeable, and cash. The list of investments held by Aberdeen as at 17TH November 2008 is as follows:-

	Amount £m	Yield %	Maturity Date
Unicredit Spa CD	2.0	6.21	24.12.08
Clydesdale Bank CD	2.1	6.24	30.12.08
UBS CD	2.45	6.24	31.12.08
RBS CD	2.0	6.25	09.01.09
Abbey National CD	2.3	6.28	26.01.09
Coventry BS CD	1.0	6.29	05.02.09
Barclays Bank CD	1.4	6.38	04.06.09
Nationwide BS CD	2.1	6.39	23.06.09
RBS CD	2.15	6.4	25.06.09
Alliance & Leicester CD	1.8	6.42	06.08.09
BOS (Gov guarantee)	2.2	5.91	19/10/09
HSBC Current account	0.1		
Accrued interest	0.7		
	22.3		