ITEM NO: 10

BRENT COUNCIL	**Performance and Finance Select Committee** 4th November 2008 **Report from the Director of Finance and Corporate Resources**
	Wards: ALL
Deposits with Icelandic Banks	

1. SUMMARY

1.1 This paper looks at the background to the deposits made with Icelandic banks, actions being taken across the whole loan portfolio to further reduce risk and the potential consequences for Brent.

2. RECOMMENDATIONS

2.1 To note the position of the Council's deposits held by the Icelandic banks and the actions taken to ensure they are repaid in full.

2.2 To endorse the measures taken to restrict the lending list for the foreseeable future to reduce risk within the portfolio.

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	Repayment due 14.11.08
Glitnir Bank	£5m	5.85%	Lent 15.09.08	Repayment due 12.12.08

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. Contacts with the administrator have indicated some optimism that the deposit will be repaid as the book value of assets appear to be in the same order as the liabilities. However, there will be little clarity until November at the earliest. Glitnir is being administered by the Icelandic equivalent of the Financial Services Authority. Although the UK, Danish and Icelandic governments are now in discussion, there are no indications as yet on repayment of the deposit. The International Monetary Fund announced a rescue package for Iceland this week.

3.1.2 A large number of other local authorities (at least 120, who are owed approximately £859m) have also invested in Icelandic banks, as has the Audit Commission, Police Authorities, Transport for London, charities and other public bodies.

3.1.3 The Council has no direct investments through the Pension Fund in Icelandic banks.

3.2 Background to the Financial Crisis

3.2.1 The current financial crisis has its background in credit creation over the last ten years – particularly in the USA, but also in UK and elsewhere. The major banks were seeking new ways to increase earnings, house prices had risen strongly and were expected to continue upwards. Inflated loans were made to purchasers who could not afford the repayments, especially when ultra-low introductory interest rates rose. However, banks believed that by parcelling the loans with other, safer loans, and lending these on to other institutions, risk would be spread and the originating banks would not suffer in any correction. However, not only did originating banks continue to hold some of these parcels of loans through off-balance sheet financial vehicles, but they sold some to other banks, and others to investors for whom the instruments were totally inappropriate and incomprehensible. In addition, these packages have been further split, repackaged and sold again, so that it is difficult to know who now holds the risk relating to troubled assets.

3.2.2 As the USA property market fell in 2007, house buyers defaulted on their loans. Banks, financial authorities and markets became aware of the problems, so that by mid 2007 the lending between financial institutions (known as the wholesale or inter-bank market) for anything other than very short periods began to cease for some institutions. Some banks had become very dependent on the inter-bank market for loans – they did not have a large deposit base to sustain their business models. The very public evidence of this problem was Northern Rock, and to a lesser extent Bradford & Bingley and Alliance Leicester. When concerns about Northern Rock became public, depositors rushed to withdraw their funds and the bank could not borrow on the inter-bank market, with the result that the bank had to be nationalised.

3.2.3 However, the crisis has continued to grow. The inter-bank market had remained very restricted, with banks afraid to lend to one another for anything other than very short periods for fear that the receiving bank had low quality loans on its books. The inter-bank rate has remained well above the level of bank rate by some 1% - 1.75% - the two rates are usually quite close. In UK, banks have made rights issues to strengthen their capital bases. The same has occurred in USA. All to no avail.

3.2.4 The last six months have seen very serious attempts to solve the underlying problems of bank capitalisations and the freezing of the inter-bank market. The actions have become increasingly necessary as the shortage of money to lend has spilled over into the real economy – there is less credit for house purchase, further undermining property markets, and less available for business. In USA, the government and the Federal Reserve (Fed) have encouraged strong institutions to take over weaker institutions, encouraged the raising of new capital, and lent money to the markets to try to encourage confidence and liquidity. However, the perceived implications of the collapse of Lehmans in September and the nationalisation of Fannie Mae and Freddie Mac (the two USA home loans institutions) with resultant loss to shareholders, undermined sentiment further so that banks were frightened to lend to other banks for fear of not being repaid. This has led to the near collapse of various highly rated banks which have required takeovers or support – for example HBOS, Fortis, Dexia, Depfa, Wachovia, Merrill Lynch and others.

3.2.5 The Icelandic banking sector has grown strongly in recent years, supported by both a strong economy and a rising currency. The banks have enjoyed improved credit ratings. However, when credit ratings were lowered on 30th September and lenders began to withdraw deposits that could be recalled at once (known as call money), Icelandic banks were short of liquidity. The Icelandic government, representing a small economy and only 300,000 people, felt that it could not support its banks. Initially the government sought to nationalise banks, but then placed all but one bank in administration as the scale of the problems became clear. The UK government responded to fears about monies owed to UK depositors by placing UK based Icelandic assets in UK administration.

3.2.6 Recently governments have begun to introduce packages that should address the underlying weaknesses in the financial markets. In UK, Europe and USA, public money is being put into banks in the form of partial nationalisation. This will address concerns about the capital base and allow the removal of low quality loans. Money is also being lent to financial institutions to encourage them to lend to other banks. Interest rates are being cut to encourage borrowing and lending activity.

3.3 Brent Council's Treasury Management Strategy

3.3.1 Treasury Management is a significant function for local authorities. Brent's in-house team lent a total of £969m in 2007/08, at rates between 4.71% and 6.59%. The amount available to lend tends to vary between £90m and £130m. In addition, the external manager, Aberdeen Asset Management, controls a portfolio worth £21.9m. The in-house team also managed long term debt valued at £607.3m as at 31st March 2008.

3.3.2 The capital financing budget is a major area of expenditure and income within both the General Fund and HRA. 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 £m	Average rate %
2006/07	5.0	4.7
2007/08	6.2	5.3
2008/09 (expected)	6.1	5.5

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. When the list was reviewed in 2006, the option to weaken credit quality to enhance interest receipts was rejected because the risks were perceived as too great. However, having a fairly sizeable lending list that includes overseas banks and does not rely on UK clearing banks that borrow in large amounts, is regarded as necessary to maximise opportunities.

3.3.3 Active treasury management seeking to balance returns with risk is therefore vital to the overall revenue budget of the Council and the funding of services. A reduction in the average rate of interest achieved on deposits would have had a considerable effect on the Council's overall financial position. Just a 0.5% reduction in the average rate of interest earned over the past three years would have deprived the council of £1.7m in resources.

3.3.4 The Council has a significant amount of cash deposited in the money market. This cash comprises a number of items, e.g. balances and reserves, council tax income, grant income, capital and Section 106 receipts unapplied, business rates income, etc. It also includes amounts borrowed to fund future capital schemes as we undertake this borrowing at the most opportune time rather than the day before the capital expenditure is incurred. As at 9 October 2008, the Council held £129.14m in deposits (see Appendix 1). A number of press reports have expressed surprise at the size of deposits held by local authorities. It is however a reflection of the complexity of a local authority's activity and prudent financial management.

3.3.5 The Chartered Institute of Public Finance and Accountancy (CIPFA) issued a revised Code of Practice on Treasury Management in Local Authorities in 2002, and Full Council adopted the Code in September 2002. The revised Code reinforces the need for policies and practices to manage treasury activities. Under the Code, all members at Full Council receive two reports on treasury activity every year – the first setting out the treasury strategy for the year ahead, the second setting out the results of the treasury activity for that year. In the outturn report, treasury management is defined as 'the management of the local authority's cashflows, its banking, money market and capital market transactions; the effective control of the risks associated with those activities; and the pursuit of the optimum performance consistent with those risks'. This means that the pursuit of additional returns must be placed within the framework of the prudent protection of the council's cash balances and a rigorous assessment of risk. As part of the prudential approach (under the Prudential Code) the Council has only invested in a fairly narrow range of financial instruments – managers are allowed to use cash, gilts, certificates of deposit and commercial paper, but not equities, property or a wider range of instruments.

3.3.6 A key part of the strategy and risk management is the treasury lending list agreed by the Director of Finance. The list has been established and refined over a long period of time, and is constructed on the basis of the control of risk (credit ratings), the spreading of risk (maximum amounts that can be lent to particular institutions) and the period deposits can be placed. The list has been constructed in consultation with our Treasury Adviser, currently Butlers, previously Sector (changed in Spring 2007). Butlers and Sector are the largest two local authority advisors. The adviser was changed following a formal review, in which Butlers offered a higher standard of advice and support. The adviser provides market information (interest rates and credit ratings), advice on debt restructuring and lending, and training / advice on changes in accounting and financial regulations. However, Butlers keep strict 'chinese walls' between its activities as an adviser, and the activities of its broking parent (ICAP). The lending list was fully reviewed in 2006 and has been regularly reviewed and updated subsequently. 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. In the current market turmoil, overseas banks and lower rated UK banks have been removed from the list.

3.3.7 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. This approach should reduce risk, and is followed by a number of other authorities, although 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. The Brent list does not contain any BBB institutions.

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. The Brent list uses F1 (P1 Moody's).

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. 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. The Brent list does not go below C.

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. The Brent list uses a minimum rating of 3, moderate probability of support.

As part of the on-going review financial institutions have been removed from the lending list when their ratings have changed adversely. For example, the German Landesbanks were removed from the list when their guarantee from state governments' was withdrawn. It is clear through contacts with other London boroughs and Butlers that the Brent list is both fairly standard and conservative in approach, looking for high quality institutions.

3.3.8 Icelandic banks entered the Brent lending list in 2006 when their general credit ratings were raised and they then met the Brent criteria. A number of deposits were made with Kaupthing, Singer and Friedlander (a financial institution that was on the lending list before 2006 when it was owned by a South African company) and duly repaid. Brent has made two deposits with Glitnir Bank – the first was repaid on time. Only one loan has been made to Heritable Bank.

3.3.9 The deposit of £10m was made with Heritable Bank, a subsidiary of the Icelandic bank Landsbanki, on 15th August 2008. The deposit is due to be repaid on 14th November. The credit ratings on 15th August were A long term (high credit quality), F1 short term (highest credit quality), C individual (an adequate bank) and 1 Support (extremely high probability of external support). In short, the ratings enjoyed by Heritable were strong – the bank was placed in administration when its ratings were reduced later, loans were recalled leading to a liquidity shortage, and no help was forthcoming from the Icelandic government. The deposit of £5m was made with Glitnir Bank on 15th September, and was due to be repaid on 12th December. The credit ratings on 15th September were A- Long (high credit quality), P1 short (Moody's highest credit quality), B/C Individual (a strong bank), and 2 support (high probability of external support). These ratings allowed a loan of up to £5m for up to 3 months duration. It was not until the 30th September 2008 that the credit agencies significantly reduced the Icelandic banks ratings.

3.4 **Financial Implications**

3.4.1 This section of the report quantifies the possible loss to the Council. There are a number of scenarios relating to the interest due:

(i) If the deposits are returned on time, but without the interest due, the cost would be £220,000. The Council will be claiming the full interest due.

(ii) There are cash flow consequences involved if both deposits are returned, but repayments are after the due date. If the deposits are not returned before the end of the financial year, the additional cost would be a further £235,000 on top of the £220,000. Again any claim will include full interest repayment.

(iii) In the event that the £15m is not returned additional borrowing in a full year, (assuming a rate of 4.5%) the cost would be £675,000.

3.4.2 If the Council does not recover the full £15.0m or only part and/or the interest due on those deposits, it will need to consider appropriate actions to mitigate those losses, including:

- reducing the interest budget by drawing down on balances and reserves or other savings although this budget is currently projecting a surplus;
- writing off the proportion of the principal to the General Fund, and Housing Revenue Account;
- reviewing the capital programme to identify the scope to reduce or re-phase existing capital schemes;
- reviewing the timing of future large payments to enable the re-profiling of the Council's cash flow;
- reviewing all service budgets to identify additional savings as part of the 2009/10 budget process.

3.4.3 The Government has already indicated that it will consider the option of issuing capitalisation directions to authorities to allow them to spread any loss over a number of years. This will clearly reduce the overall immediate impact.

3.5 Actions Taken to Date and Response of UK Government

3.5.1 In 2007 officers took early action to remove Northern Rock, Bradford & Bingley and Alliance & Leicester from the lending list when it was perceived that they would suffer problems with liquidity.

3.5.2 On 30th September 2008, the Director of Finance reduced the number of financial institutions on the lending list following the nationalisation of various European and USA financial institutions. The relatively lower rated UK and overseas institutions, including Heritable and Glitnir, were removed from the list. On 8th October, the list was further reduced to exclude all overseas banks. The aim was to reduce risk in a period of very high uncertainty.

3.5.3 On 7th October, Glitnir and Landsbanki (the parent of Heritable) were placed in administration, while Kaupting (another Icelandic bank with which deposits have previously been made) was nationalised. The British government became concerned that the Icelandic authorities intended to protect their citizens at the expense of British depositors, and placed UK based assets such as Heritable in administration in UK. Officers have made contact with the administrator, Ernst & Young to begin the process of registering a claim. However, there is as yet no information on registering claims in Iceland for repayment of deposits with Glitnir.

3.5.4 Although the Brent lending list has been restricted to UK institutions, the deposit with Rabobank is scheduled to continue until 23rd February 2009 (see Appendix 1). Rabobank is a large, highly rated Dutch bank with strong credit ratings (AA+ long, F1+ short, A individual and 1support), and is very unlikely to founder. Any attempt to recall the loan now will be expensive in terms of penalties. The external treasury manager, Aberdeen Asset Management, has £2.45m in Certificates of Deposit (CDs) with UBS Bank to the end of December (AA+ Long, F1+ short, A/B individual and I support), and £2m in CDs with UniCredito Italiano SpA to 24th December (A+, F1, B/C, 1). These are also strong ratings. UBS has been supported by the Swiss government.

3.5.5 Previous experience of banks placed in receivership/administration give cause for optimism for recovering the deposits. When British and Commonwealth bank went into receivership in 1990, Brent recovered its deposit – the receiver sold off assets over a period, rather than in a fire sale, and repaid all debts. Barings bank became insolvent after unauthorised trading in Japanese stocks (the Nick Leeson affair), but Ing bank intervened and repaid creditors. Even in the case of BCCI, where fraud and money laundering occurred, 93% of debts were repaid over a period.

3.5.6 The Local Government Association (LGA) is having detailed discussions with government departments, local authorities, CIPFA and the administrators. In particular, the LGA is liaising with the Treasury and the Department of Communities and Local Government (DCLG) to ensure that authorities with immediate concerns – cash flow problems – are supported and that there is an appreciation of the various issues. Pressure is being applied to encourage the UK government to have discussions with Icelandic authorities to seek repayments. It is understood that discussions with both Iceland and Denmark have commenced. LGA, CIPFA, DCLG, and the Audit Commission are looking at accounting issues. Brent is in close contact with the LGA and London Councils. A strong case is being made that the UK Government *"baled out"* the major clearing banks and other institutions but is not adopting the same principles for local authorities. It is likely that they will await the outcome of the administrators work before reaching a final decision.

3.5.7 A joint statement from the Government and the LGA on 9th October stated that there was no evidence of recklessness by local authorities, see Appendix 2. They also agreed that local authorities were correct to work within a financial framework that struck an appropriate balance between security of deposits and returns, and that it appeared this framework had been adhered to.

3.5.8 Government's current focus with local authorities has been on assisting where short term cash flow issues may prove a problem. This is not the case for most authorities and speculation about wages and bills not being paid is not realistic.

3.5.9 On 14th October 2008, the LGA made a further statement – see Appendix 3.

3.6 Summary and the Way forward

3.6.1 The recent position that emerged with the Icelandic banks was unprecedented. Inevitably, given the scale of the frozen deposits, doubts have been cast about the effectiveness of the controls in place in local authorities for Treasury Management. A number of the issues raised are set out below:

(a) There were warnings from several sources that the Icelandic economy and its banks were expanding too rapidly and was therefore potentially a higher risk than reflected in the ratings.

(b) Deposits should have been held in *"safer havens"* particularly given the turbulence in the world banking system.

(c) Deposits should have been limited to the UK.

3.6.2 The Council's position on the above reflects much of that contained in the statements of the LGA attached as Appendix 2 and 3 and is set out in some detail in the report. In summary our lending was within the agreed guidelines of putting funds into a wide range of institutions with strong credit ratings. However, we are not in any way complacent, given the outcome, and we must learn any lessons and ensure risk is further minimised in the future. The LGA, FSA and the Audit Commission will be involved in reviewing the overall position. The Council is also considering its own independent review being commissioned to concentrate on the following main areas:

- the adequacy application and effectiveness of the Council's investment strategy;
- the adequacy of the Council's associated internal control systems;
- the effectiveness of the application of these control systems in practice;
- recommendations for strengthening internal controls.

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

Appendix 1

Brent's Current Lending List

1. The current loans outstanding are:

Name	Amount £m	Date Taken Out	Maturity Date
Rabobank	5.0	23.02.06	23.02.09
RBS	5.0	23.10.06	15.02.09
HBOS	5.0	16.04.07	16.04.10
HSBC	5.0	18.04.07	19.04.10
HSBC	5.0	15.06.07	15.06.10
Cheshire Building Soc	5.0	30.07.07	30.07.09
Derbyshire BS	5.0	15.05.08	30.02.09
Global Treasury Fund (RBS)	7.1		Call
Gartmore cash reserve	0.1		Call
Cheshire BS	5.0	07.05.08	07.05.10
Heritable bank	10.0	15.08.08	14.11.08
Stroud & Swindon BS	5.0	15.08.08	29.12.08
Bank of Scotland	5.0	15.08.08	16.02.09
Glitnir	5.0	15.09.08	12.12.08
Dunfermline BS	5.0	04.02.08	04.02.10
Lloyds TSB	5.0	15.02.08	15.02.11
Newcastle BS	5.0	28.04.08	28.04.10
Derbyshire BS	5.0	16.06.08	16.06.10
Dunfermline BS	5.0	01.07.08	01.07.10
Skipton BS	5.0	01.07.08	01.07.11
RBS	5.0	22.09.08	22.09.11
Total	**107.2**		

2. Brent has also invested £21.94m with an external manager, Aberdeen Asset Manager, which has placed the fund in a mixture of certificates of deposit (mainly) and cash.

Appendix 2

Joint Statement from Government and LGA (9th October 2008)

We had a very productive meeting and we agreed to stay in close touch, meeting again next week. Government and the LGA agreed that there is no evidence of recklessness by local authorities. They also agreed the financial framework for local authorities, which requires them to strike an appropriate balance between security of investments and returns, appears to have been adhered to.

Many authorities have already publicly stated that any risk is not a threat to frontline services but a small number of authorities may have specific problems.

We agreed once the LGA completed its analysis of the effects of the situation on individual local authorities, we will look at issues arising on a case by case basis. For those local authorities who are facing severe short term difficulties Government and the LGA will agree an appropriate set of ways to assist. We will judge what's appropriate on a case by case basis but in previous situations support has included helping local authorities restructure their financial priorities, providing additional expertise and capitalisation of expenditure.

The Government and international partners have already acted to support stability of the banking system. Action has also been taken in relation to the position of Icelandic banks – including freezing assets of Landsbanki. Local authorities, along with all other investors, will benefit. The LGA will be seeking to open discussions with administrators of the UK subsidiaries. The LGA and Government encourages all councils to continue operating investments in accordance with the guidance.

LGA and Government will continue to monitor the situation closely.

Appendix 3

LGA Statement (14th October 2008)

Cllr Margaret Eaton, Chairman of the LGA, said:

"This isn't the time for a blame game. This is an unprecedented situation, the extent of which could not have been foreseen. However, at the appropriate moment, there needs to be a full and independent inquiry to find out just how these banks continued to get relatively strong credit ratings until a few days before they went under.

"No council should rely solely on credit agencies and must use their financial nous. But there must be confidence in credit ratings as councils continue to invest billions of pounds in a whole range of financial institutions. Our analysis dispels the myth that many councils were investing recklessly after credit warnings were issued.

"The good news for council taxpayers is that discussions with the administrators have been hugely encouraging. The administrators considered that the book value of the assets of each business appeared to be of the same order of magnitude as the liabilities, although it is too early to give exact figures.

"The evidence shows that, overwhelmingly, town halls have acted prudently and within strict guidelines to get the best rates of interest on savings whilst investing in institutions deemed to be strong. If it is discovered that individual councils invested significant sums following the credit rating downgrading, the LGA expects them to set up their own inquiries to find out what happened.

"Prudent financial management means that councils put their money into a diverse range of banks to make sure that any risk is spread to minimise the impact of problems in the financial markets. We are not aware of councils that are in serious imminent liquidity problems and in the long term we are confident that vital frontline services will remain unaffected."