ITEM NO: 5

	Performance & Finance Select Committee 8th December 2008 **Report from the Director of Finance and Corporate Resources**
For Action	Wards Affected: ALL
Report Title:	**Deposits with Icelandic Banks - Update**

1. SUMMARY

1.1 This paper sets out progress with the recovery of deposits made with Icelandic banks, the current lending list and recent deposits made, and options for members' scrutiny of the Council's investment strategy.

2. RECOMMENDATIONS

2.1 Members are asked to comment on the proposals on scrutiny of the Council's investment strategy (para. 3.4.1) and training (para. 3.4.2).

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, Chelsea Building Society and others.

3.1.2 Brent is working with other local authorities, the Local Government Association (LGA) and other organisations such as 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, Barnet and Kent, 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) Prepare a bid to the Department for Communities and Local Government (DCLG) for authority to capitalise the deposits and lost interest to mitigate the short term effects of non-recovery.

3.1.3 The administrators for Heritable, Ernst & Young, have taken some preliminary steps to identify the assets and debts of the bank. It would appear that there are sufficient assets to repay loans but Heritable has given loans for the purchase of property, an asset that has fallen severely in value. Much depends on when the loans were made and the security held. In more detail, some loans are for buy-to let properties, and are self-certificated. In the current climate, the loans may be difficult to package and sell. The administrators will be urged to be patient to obtain the best prices, but progress may be slow.

3.1.4 The administration of Glitnir bank is being undertaken in Iceland by a qualified Resolution Committee. The assets of the bank have been divided between 'new' Glitnir, being the Icelandic assets of the bank that are important in the operation of the Icelandic banking system which had been 'frozen' by the collapse of Glitnir, Landsbanki and Kaupthing, and 'old' Glitnir. The latter composes the non-Icelandic assets, including Scandinavian and UK aspects, which will be assessed to ascertain repayments to creditors. It is expected that there will be a progress statement in February 2009. Again, it would appear that there are sufficient assets to repay creditors, but the rapid expansion of Glitnir and doubts about some of the valuations mean that there are more concerns about Glitnir than about Heritable.

3.1.5 A report is being prepared for the Audit Committee, detailing internal controls on lending, outlining the response to the problems with Icelandic banks, and setting out proposals to improve member scrutiny and training.

3.2 Current Treasury Management Activity

3.2.1 A key part of the Treasury Management strategy is the treasury lending list agreed by the Director of Finance. The list had been established over a long period of time, and was constructed on the bases of the control of risk (credit ratings) and the spreading of risk (maximum amounts that can be lent to particular institutions). 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. 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 were removed from the list on 8th October (see Appendix 1) leaving only highly rated UK banks, building societies, supranational authorities supported by international and national organisations, AAA rated money market funds that only invest in short term financial instruments that allow extra yield but excellent liquidity, and governmental institutions. The external manager, Aberdeen Asset Management, uses the Brent list but also cross-references to an in-house list. Appendix 2 sets out the criteria used by credit ratings agencies to assess the credit worthiness of financial institutions.

3.2.2 Appendix 5 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.

3.2.3 In 1998, members agreed to the appointment of two external treasury managers who had skills to use a wider range of investment instruments than could be accessed by the in-house team. 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.

3.2.4 Appendix 3 sets out deposits outstanding as at 23rd October (30th September for the external manager, Aberdeen). Appendix 4 sets out deposits outstanding as at 24th November (17th November for Aberdeen). Other deposits have been made, and expired, between 23rd October and 24th November – these were short term and in accordance with the lending list. The changes between Appendices 3 and 4 are as follows:-

a) Deposits with the two Money Market funds (RBS and Gartmore) to preserve liquidity and maintain yields as interest rates fell sharply.
b) Scarborough Building Society, £5m at 5.68% to 19th December. The deposit is at a good rate and matures to coincide with payments to the Inland Revenue.
c) The list for Aberdeen has seen the Lloyds Bank CD mature, to be replaced by a £2.2m CD with Bank of Scotland which is issued with a government guarantee and improved yield.

3.2.5 All deals are made with highly rated financial institutions. They have been made in accordance with the London Code, which is 'my word is my bond', which has previously obviated the need for collateral or insurance. It is understood that no local authorities have found it necessary to take out any insurance for such deposits – in almost every case, loans have been returned. The options around insurance will be investigated. However, it should be noted local authorites do not have powers to use derivatives, such as credit default swaps, that are the basis of insurance products.

3.3 Lending List – Options under consideration

3.3.1 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 £m	Average rate %
2006/07	5.0	4.7
2007/08	6.2	5.3
2008/09 (expected)	5.5 / 6.0	5.0 / 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 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.

3.3.2 To place paragraph 3.3.1 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.

3.3.3 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.

3.4 Management Information and Training for Members

3.4.1 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.

3.4.2 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

Report to Budget Panel – 23rd October 2008

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

APPENDIX 1

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
West Bromwich
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 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.
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.
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

Brent treasury lending list – Icelandic banks – 23rd October 2008

1 The current loans outstanding are:

Name	**Amount £m**	**Yield %**	**Lending Date**	**Maturity 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	7.1			Call
Gartmore cash reserve	0.1			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
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	107.2			

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 (CDs), usually of one year duration, and cash. The list of investments held by Aberdeen as at 31st September 2008 is as follows:-

	Amount £m	**Yield %**	**Maturity Date**
Lloyds Bank CD	2.1	6.09	20.10.08
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
HSBC Current account	0.05		
Accrued interest	0.49		
	21.94		

APPENDIX 4

Brent treasury lending list – Icelandic banks

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

Name	**Amount £m**	**Yield %**	**Lending Date**	**Maturity 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		

APPENDIX 5

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.