

<b>Scrutiny Committee</b>	<b>Agenda Item No. 7</b>
<b>10 November 2008</b>	<b>Public Report</b>

## **Report of the Executive Director - Strategic Resources**

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### **REPORT TITLE**

#### **1. PURPOSE**

- 1.1 This report has been requested by members of Scrutiny Committee following the failure of Icelandic banks, Landsbanki and Kaupthing Bank, and their UK subsidiaries, in which the City Council had deposited £3 million.

#### **2. LINKS TO CORPORATE PLAN, SUSTAINABLE COMMUNITY STRATEGY AND LOCAL AREA AGREEMENT**

- 2.1 This is a corporate finance matter underpinning the corporate plan.

#### **3. BACKGROUND**

- 3.1 The purpose of this report is to respond to specific questions raised by members of the Committee and to provide further explanatory detail on the Council's investment practices and how the global financial credit crisis, which is without precedent, is having upon its investment strategy.
- 3.2 The Council has been in liaison with the Local Government Association (LGA) and has received updates of the LGA's discussions with the Administrators of the failed banks, the Government and other agencies. The LGA has confirmed that the latest information is that there have been 123 local, fire and police authorities that have been affected by the closure of Icelandic banks, and their UK subsidiaries, involving investments totalling £919.6 million. The list of authorities affected is at Appendix A and an L.G.A question and answer document at Appendix B.

#### **4. KEY ISSUES**

- 4.1 The Council annually approves a Treasury Management Strategy Report as part of its Medium Term Financial Strategy; this is a requirement of the "CIPFA Prudential Code for Capital Finance in Local Authorities" which was adopted by the Council. The Local Government Act 2003 and the "Prudential Code" introduced new requirements for the manner in which capital spending plans are to be considered and approved; it requires the development of an integrated treasury management strategy.

This strategy covers:

- the current treasury position;
- borrowing requirement;
- prospects for interest rates;
- the borrowing strategy;
- the investment strategy;
- treasury limits in force which will limit the treasury risk and activities of the Council.

- 4.2 Treasury Management is the detailed day-to-day management of the Council's cash flows, banking, investments and borrowings. Responsibilities include monitoring functions and policies, taking decisions in relation to capital financing and borrowing, and ensuring that the systems which control the functions are developed and observed.
- 4.3 This function operates under the powers delegated to the Director of Strategic Resources and the daily treasury management activity is conducted in the Finance Division within Strategic Resources. The policy in relation to borrowing and the investment of cash resources not immediately required are reviewed at least quarterly and advice is obtained from Sector Treasury Services Ltd, whom the Council retains on a fee basis.
- 4.4 The Council's primary treasury management objectives are:
- (a) to reduce the revenue cost of the Council's debt in the medium term by obtaining financing at the cheapest rate possible in the light of current interest rate forecasts;
  - (b) to seek to reschedule debt at the optimum time; and
  - (c) to invest available cash balances with a spread of dependable institutions over a spread of maturity dates and periods of notice at interest rates that are higher than the cost of borrowings.

## **5. ANNUAL INVESTMENT STRATEGY**

- 5.1 Each year the Council approves an Annual Investment Strategy, which provides the framework and delegations in accordance with the guidance for investment decisions. Key factors taken into account when making investments include security first and foremost, liquidity and finally yield. The Council uses Fitch credit ratings, with minimum ratings of "F1" for short term and "A" for long term.

The Annual Investment Strategy aims to:

- ensure that sums are invested with credit worthy organisations to limit the exposure against loss;
  - maintain sufficient access to funds for its perceived needs;
  - achieve advantageous returns commensurate with security, liquidity requirements, debt management alternatives and interest rate forecasts, and
  - have a flexible, responsive approach towards bodies with which it invests funds.
- 5.2 Speculative investments such as trading in shares are avoided and particular emphasis is made to the credit quality of counterparties before deposits are made. The Council uses credit ratings published by Fitch Ratings Ltd and other internationally recognised agencies e.g. Standard and Poor's or Moody's Investor Service Ltd. All credit ratings are monitored at least monthly and may result in a counterparty being removed, suspended or upgraded on the Council's operational List of Acceptable Investment Counterparties. Additionally the Council receives treasury management advice from the market leader in the local authority sphere, Sector Treasury Services Ltd, and from brokers operating in the UK money market.

## **6. IMPLEMENTATION OF THE ANNUAL INVESTMENT STRATEGY**

- 6.1 The Council operates in accordance with Office of the Deputy Prime Minister (ODPM as was) Guidance and "Treasury Management in the Public Services: Code of Practice" as laid down by the Chartered Institute of Public Finance and Accountancy (CIPFA). The UK financial sector is regulated by the Financial Services Authority.
- 6.2 When making investments the Council is required to ensure that the investment is both secure as far as practicable and accessible to assist with its cash flow. Based on this the market is monitored to ensure the optimum return on investments commensurate with the dependability of counterparties and a spread of maturity dates.

- 6.3 In order for a deposit to be agreed, the counterparty should be a body that is an authorised deposit-taking institution, subject to regulation in the UK and have a “high credit quality” rating or meet other credit worthiness criteria. Examples of acceptable counterparties include the UK Government and agencies, local authorities, major UK and European banks and building societies, some of which will be household names and others that are less well known to the general public.
- 6.4 To further manage risk the Council limits amounts that may be lent to any one institution, operates with a spread of counterparties and over a range of investment periods.
- 6.5 The Council invests reserves and cash flow surpluses throughout the year to generate investment income. These reserves include earmarked monies set aside for specific projects or service areas, expected future commitments and for general contingencies. Some of these balances belong to Peterborough's schools.
- 6.6 The Council currently has a non-speculative portfolio of deposits with 29 banks and building societies that totals £81 million. It manages its cash on a daily basis and its treasury activity turnover totals around £700 million per annum. In 2007/08 the Council generated £4.6 million in interest minimising the amount needed from council taxpayers to provide services to the public.

## **7. COUNCIL'S INVESTMENTS WITH HERITABLE BANK LTD AND KAUPTHING SINGER & FRIEDLANDER LTD (IN ADMINISTRATION)**

- 7.1 In April 2007 the City Council made two fixed term, fixed interest rate deposits of £1 million with Heritable Bank Ltd, the UK subsidiary of Icelandic bank, Landsbanki, and £2 million with Kaupthing Singer & Friedlander Ltd, the UK subsidiary of Kaupthing Bank, for a period of two years.
- 7.2 Heritable Bank was a 130 year old British bank with published assets of £1.2 billion, and similarly Kaupthing Singer & Friedlander Ltd was another 100 year old large British bank that had dealings with the commercial sector. Both of these banks were placed into administration by the UK regulator, the Financial Services Authority, in consultation with HM Treasury on 7<sup>th</sup> and 8<sup>th</sup> October respectively.
- 7.3 At this moment in time the banks' administrators, accountants Ernst & Young, are assessing their financial position and their ability to repay depositors. The banks' last financial statements show that they were well funded and profitable. When the deposits were made both banks had been rated as “high quality” by the credit rating agencies that measure the financial standing of financial institutions and their ability to repay depositors. They were still well regarded by the credit rating agencies until shortly before being placed into administration.
- 7.4 Although up to the time Heritable Bank and Kaupthing Singer & Friedlander were placed into administration the credit rating agencies that monitored the banks still believed them to be of high standing. The Council had not made any investments in either bank since June 2007. However it was not possible to recall any existing deposits as these had been contractually agreed for a fixed term. Early redemption was not possible as the global banking crisis deepened and all financial institutions, including Heritable and Kaupthing Singer & Friedlander, focussed on retaining the deposits that they had on their books.

## **8. CHANGES TO THE COUNCIL'S INVESTMENT PRACTICES**

- 8.1 In the current prevailing circumstances the Council has recently adopted a very cautious approach and has restricted all new treasury transactions to the UK Government and agencies, local authorities, major UK clearing banks and the largest UK building society.
- 8.2 The following actions have been implemented:
- New call deposit facilities have been arranged with the Debt Management Office, which is part of HM Treasury, and the Council's main bank, Barclays, to replace the facilities with

Abbey PLC, Alliance & Leicester, Bank of Scotland and Barclays Global Investors Money Market Fund.

- Fixed short term and overnight investments will be made in the most secure place possible, namely the HM Treasury deposit facility, once surplus funds have been accumulated. The Barclays call deposit facility is being used as a cashflow contingency reserve to allow for unforeseen payments and receipts and for non-marketable (small) surplus balances.
- Prior to the deployment of the HM Treasury account, investments are to be only negotiated and dealt with large UK domiciled financial institutions that have non – foreign ownership and which have UK Government backing or deemed to be of high quality standing.
- The intention is that all short term fixed period deposits will be placed in the HM Treasury account in future. This is a temporary measure necessitated by the exceptional global banking crisis and is to remain in place until further notice.
- The Approved Investment Counterparty List has been reduced to UK Government agencies, major UK clearing banks and the largest UK building society, Nationwide. The maximum investment limits approved by members within the Annual Investment Strategy, approved financial instruments and investment durations remain unaltered.
- Call deposits currently with institutions that are domiciled abroad or have foreign parents have been recalled and reinvested in accordance with the revised Approved Investment Counterparty List and no additional deposits are being made into these facilities until further notice.
- All other existing fixed term investments negotiated with institutions on the previous Approved Investment Counterparty List stand and will be allowed to repay to the Council on maturity. The previous Approved Investment Counterparty List comprised UK Government agencies, UK and foreign owned banks based in the UK and abroad, Barclays Global Investors Money Market Fund and UK and foreign based building societies that may / may not have credit ratings.

## **9. SPECIFIC QUESTIONS RAISED**

### **9.1 The reported £3m that is in an Icelandic bank, what is the status of this money and how safe is it?**

The £3m was invested in UK banks which had Icelandic Parents, the details of which are below:

#### **Heritable Bank Ltd:**

20th February 2004: New long term credit rating “A”, with a stable outlook.

This rating was maintained until 1 April 2008 when it was given a negative rating watch, i.e. concern was expressed about its long term outlook. This concern was affirmed on 9th May 2008, when it was placed on negative outlook. It was downgraded on 30th September 2008 to “BBB” rating with a negative watch.

£1m was placed on a 2 year deposit with Heritable Bank on 2 April 2007 when the Bank had an “A” rating with a stable outlook.

#### **Kaupthing Singer & Friedlander Ltd:**

22nd December 2000: Upgraded credit rating from “A-“to “A” with a stable outlook. Rating retained until 6th December 2007 when the outlook was deemed negative. On 31st January 2008 the outlook reverted to positive again. On 1st April 2008 the Bank was put on rating watch

and on 9th May was downgraded to “A-“with a negative outlook. Further downgraded to “BBB” on 30 September and then “D” on 8 October 2008.

At this stage the status of the deposit is unsure. The deposits were not due for return until April 2009. Negotiations are underway between the Local Government Association (LGA), HM Treasury and the Icelandic government in order to maximise returns. The Strategic Director of Resources has joined the LGA creditors group.

## 9.2 Where are other Council investments placed and what risks are involved with them?

As at 27th October 2008 the Council had £81m invested, of which £7m was for over 1 year.

The investments are broken down as follows:

Institution Type	Value	Risk
UK banks with Icelandic parents	£3m	Unknown as yet
Irish banks and building societies	£9m	Comprising 3 deposits guaranteed by Irish government
Major UK banks	£10m	Placed with 2 major UK clearing banks to minimise risk
UK building societies	£59m	Split over 22 counterparties to minimise risk

## 10. IMPLICATIONS

10.1 Environmental Impact - Not applicable.

10.2 Equal Opportunities - Not applicable.

10.3 Financial Implications - In the absence of a clearer picture on the two failed banks, and to be financially prudent, provision has been made, in full, of possible loss of interest of £239,000 in the latest 2008/09 budgetary forecast. This has not made a material impact on the Authority's current revenue budget. If any loss of principal arises, which is unknown at this moment in time, this would be met from the Council's General Fund, which had a balance of £6 million at 31st March 2008. The Chartered Institute of Public Finance and Accountancy (CIPFA) is drafting accounting guidance on how to account for this matter.

10.4 Legal Implications - Not applicable.

10.5 Links with Corporate Priorities – Careful management of the Council's finances, stewardship of available resources and the generation of investment income underpins the main strategic priorities. The Council does take all reasonable precautions to protect the security of its in-hand balances and endeavours to manage the risk of loss by regularly monitoring the financial markets, seeking the best appropriate market advice, employing an experienced team of in-house managers, maintaining a diverse portfolio with a range of institutions and a spread of maturity dates.

## 11. CONSULTATION

11.1 The Council continues to liaise with its treasury advisors, Sector Treasury Services Ltd, and specifically in relation to its deposits in the UK subsidiaries of the Icelandic banks, with Administrators, the Local Government Association, City Council Members, Members of Parliament and the Press.

## 12. EXPECTED OUTCOMES

*Scrutiny Committee notes this report and requests additional information as necessary.*

### **13. BACKGROUND DOCUMENTS**

(Used to prepare this report, in accordance with the Local Government (Access to Information) Act 1985)

### **14. APPENDICES**

Appendix A: The list of authorities affected.

Appendix B: L.G.A question and answer document.