



Lancaster City Council

Audit Committee Briefing 17 November 2008



BUTLERS
Excellence in Treasury Consultancy

Structure of the Presentation

- ✓ What does Butlers provide to the Council?
- ✓ Why did the Council have an investment exposure?
- ✓ Investment rules and regulations
- ✓ Assessing credit quality
- ✓ What happened to the Icelandic banks?
- ✓ The Council's position
- ✓ What happens now?

What does Butlers provide to the Council?

We provide a wide treasury support service, comprising:

- ✓ An overview of the Council's financial position;
- ✓ Interest rate and economic advice;
- ✓ Debt portfolio reviews, borrowing and debt rescheduling;
- ✓ Technical advice on capital finance, including the provision of model treasury reports;
- ✓ Training; and
- ✓ ***Provide guidance on the Council's investment structure and credit rating information from the three main agencies, Fitch, Standard & Poors and Moodys.***

Why did the Council have an investment exposure?

Analysis of Balance Sheet	31-Mar-08		31-Mar-07	
	£'000	£'000	£'000	£'000
Fixed Assets				
Operational Assets	247,135		224,454	
Non Operational Asset	29,531		39,752	
Intangible Assets	678	277,384	485	264,748
Revaluation Reserve	(6,803)		0	
Capital Adjustment Account	(173,052)		(172,867)	
Govt Grants Deferred	(51,896)	(231,791)	(46,401)	(219,325)
Capital Financing Requirement (as per CIPFA)		45,593		45,423

Borrowing – Funds longer term fixed assets

Why did the Council have an investment exposure?

Analysis of Balance Sheet	31-Mar-08		31-Mar-07	
	£'000	£'000	£'000	£'000
Funds				
Provisions	698		348	
Useable Capital Receipts	1,364		1,594	
Earmarked Reserves	11,796		8,713	
Balances	3,594		4,370	
Less FIAA Balance (unamortised prem / disc)	(980)		(1,159)	
Funds Available for Investment		16,472		13,866
Working Capital				
Creditors		13,302		10,811
less:				
Long Term Debtors	3		0	
Short Term Debtors	19,430		16,298	
Stocks and WIP	454	19,887	327	16,625
Cash Held for Creditors		(6,585)		(5,814)
Resources / Cash Available for Investment		9,887		8,052

Investments are generally shorter term

Investment Rules and Regulations – Treasury/Capital

Body	Requirements	Council Implementation
Government: LG Act 2003 - Investment Guidance MRP Guidance	Annual Investment Strategy MRP Policy	Approved through: Cabinet 19/2/08 Council 27/2/08
Professional: CIPFA Prudential Code Code of Practice	Prudential Indicators Treasury Management Strategy Treasury Management Practices	Approved through: Cabinet 19/2/08 Council 27/2/08 (TMPs do not need approval)
Bank of England: Non Investment Product Code (NIPS)	Compliance by Officers	Part of day to day TM practices

CLG Investment Guidance

- ✓ Explicitly introduced credit ratings
 - “..short-term sterling investments with bodies or investment schemes with "high credit ratings" will count as specified investments.”
- ✓ Whilst not ignoring other market data, these form the key basis for investment.
- ✓ Credit ratings are:
 - An independent assessment of an organisation
 - Gauges likelihood of getting money back on terms it was invested
 - Statement of opinion, not statement of fact – no guarantee
 - Measure of risk associated with investing with a counterparty

The Council's Main Criteria

- ✓ **Banks** – the Council will use banks which have at least the following Fitch or equivalent ratings:
 - **Short Term – F1** – *Indicates the strongest capacity for timely payment of financial commitments, may have an added '+' to denote any exceptional strong credit feature.*
 - **Long Term – A** – *denotes a low expectation of credit risk. The capacity for timely payment of financial commitments is considered strong. The capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings.*
 - **Individual / Financial Strength – C** – *an adequate bank. There may be some concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment or prospects (Fitch / Moody's only)*
 - **Support – 3** – *A bank for which there is a moderate probability of support because of the uncertainties about the ability or propensity of the potential provider of support to do so. (Fitch only)*

Butlers supply ratings from Fitch, Moody's and Standard and Poors

Some Conflicts in Practice

- ✓ Ideally use best credit ratings – AAA long term
 - But few institutions available
 - The credit ladder
 - higher rated institutions deal in large sizes
 - Less rated institutions will accommodate smaller deposits
- ✓ Spreading risk
 - Better to spread deposits – lower credit quality? or
 - Concentrate investments in 1 or 2 highly rated banks?
- ✓ Risk Vs. Performance
 - In practice Council's credit criteria is low risk, but ..
 - Continual push for better/out-performance
- ✓ DMA have been yielding 2%, deposits 2.5% to 4%+

Credit Rating Watch

- ✓ Much has been made of the early indicators of weakness in Icelandic banks through rating watch announcements:
 - Rating Watch: Ratings are placed on Rating Watch to notify investors that there is a reasonable probability of a rating change and the likely direction of such change. These are designated as "Positive", indicating a potential upgrade, "Negative", for a potential downgrade, or "Evolving", if ratings may be raised, lowered or maintained. Rating Watch is typically resolved over a relatively short period.

What Happened to the Icelandic Banks Ratings (Fitch)?

Deposit	£	Date	Ratings When Placed	Negative Rating Watch	Result of NRW	30/9/08 Rating Changes
Landsbanki	£1m	16/5/07 – 15/5/09	F1, A, B/C, 2	1/4/08, S/T, L/T, Ind	9/5/08 Ratings affirmed	F3, BBB, C
Glitnir FRA	£3m	14/1/08 – 14/1/09 (12/1/07)	F1, A, B/C, 2	1/4/08, S/T, L/T, Ind	9/5/08 F2, A-, B/C aff'd	F3, BBB-, F
K Singer & Friedlander FRA	£2m	16/5/08 – 16/5/09 (15/5/07)	F1, A, B, 3	1/4/08, S/T, L/T, Ind	9/5/08 F2, A-, B/C aff'd	F3, BBB, C

FRA – Forward rate Agreement – Contract to place funds

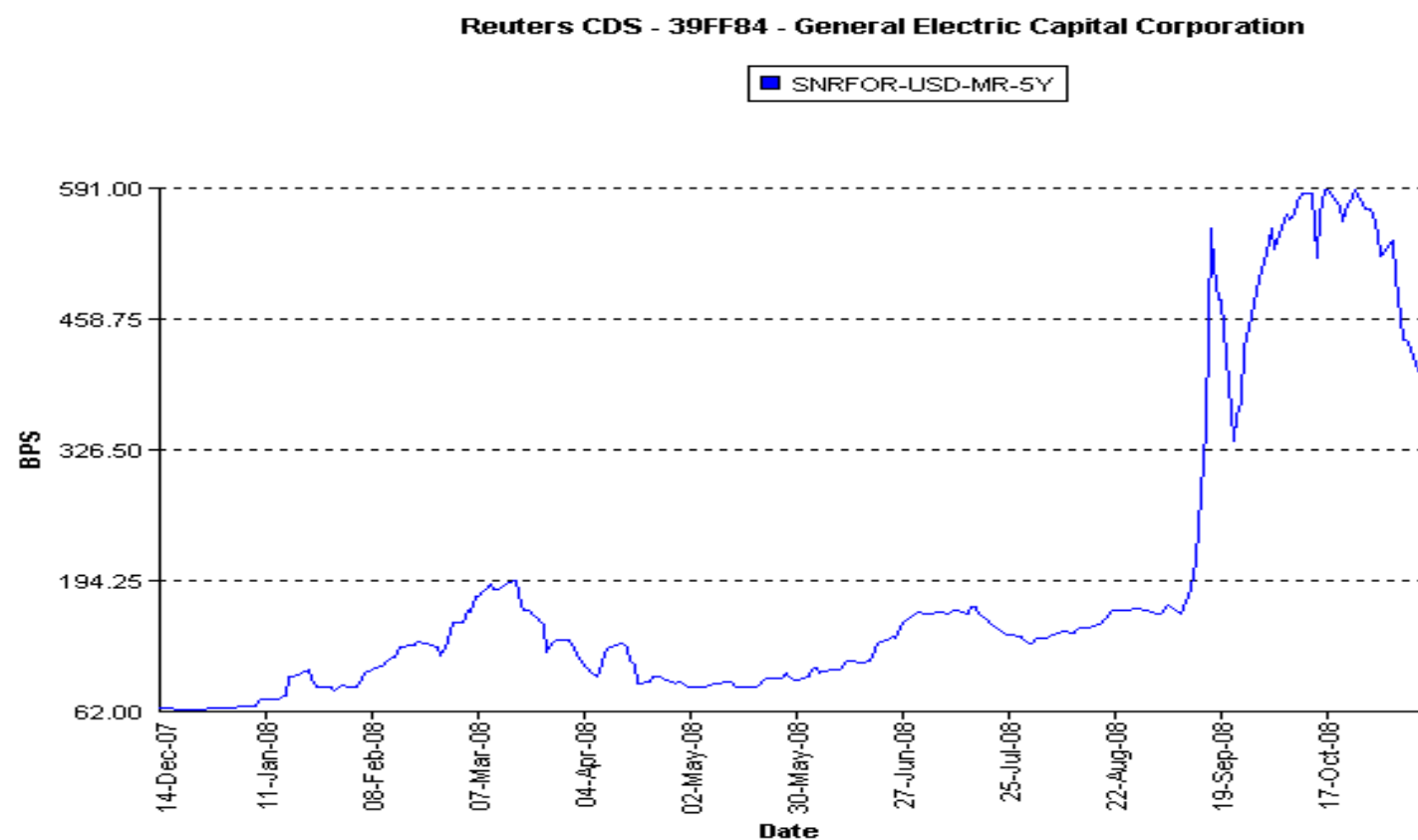
What Happened to the Icelandic Banks?

- ✓ April 2008 RWN, May 2008 affirmed or adjusted down a notch
 - ✓ Ratings changed materially 30/9/08, 7 & 8/10/08 frozen
- But..
- ✓ Underlying world banking position deteriorating
 - ✓ US sub-prime debt concerns increasing
 - ✓ Unknown exposure amongst banks, but
 - Icelandic banks little or no exposure
 - ✓ Creates fear over counterparty deposits
 - ✓ Inter-bank market becomes increasingly illiquid
 - ✓ Early October Icelandic banks lose liquidity

The Council's Position

- ✓ £6m in total due back £3m January 2009, £3m May 2009
 - £2m in administration with E&Y in UK
 - £2m KSF Ltd UK subsidiary of KSF
 - £6m in receivership under FME (Icelandic FSA)
 - £1m Landsbanki
 - £3m Glitnir
- ✓ E&Y due to report mid November 2008 with more detailed assessment
- ✓ FME:
 - Looking to re-launch the banks?
 - Will it cover existing deposits?

Compliment Credit Ratings - CDS



What Happens Now?

- ✓ Work with LGA and wait for receivers/administrators
- ✓ Depends on final payout
- ✓ If less than principal + interest:
 - Accounting
 - Expected loss charged to I&E

Then

- Government support?
 - May depend on reserves
- Capitalisation directive?
 - Would allow charge to be spread over 20 years
 - Sufficient available & case by case?

Questions