BUDGET AND PERFORMANCE PANEL

Review of Investments in Icelandic Institutions

25th November 2008

Report of Head of Financial Services

PURPOSE OF REPORT

This report provides Members with the details surrounding the placing of investments with Icelandic banks and information regarding recovery action.

This report is public.

RECOMMENDATIONS

(1) That the report be noted, and the Committee makes any further recommendations as appropriate.

1 **Introduction**

1.1 In early October the Icelandic banking sector effectively collapsed, resulting in Heritable Bank and Kaupthing, Singer and Friedlander (KSF) falling into administration, and Landsbanki and Glitnir falling into receivership. The Council has money invested in three of these institutions and concerns have been raised, in particular regarding why monies were placed with one of them in early summer and what the Council's prospects for recovery are.

1.2 In response the Chairman has agreed to an extraordinary meeting of the Committee and this report has been produced in answer to the concerns raised. In addition Richard Dunlop, a Director from Butlers, the Council's Treasury Advisors, will also give a presentation to provide further information.

2 **Current Investments in Icelandic Banks**

2.1 The Council currently has investments totalling £6M placed with three separate Icelandic banks, details of which are as follows :

Institution	Investment £	Trade Date	Start Date	End Date	Rate %	Interest £
Landsbanki Islands	1,000,000	15 May 07	16 May 07	15 May 09	6.25	125,000
Glitnir	3,000,000	12 Jan 07	14 Jan 08	14 Jan 09	5.76	173,123
Kaupthing, Singer & Friedlander	2,000,000	15 May 07	16 May 08	15 May 09	6.00	119,671

2.2 It can be seen that for two of the investments, the Start Dates are a year later than the Trade Dates. These are known as 'Forward Deals', where a contractual obligation is made at the trade date, to place money with an institution at a later date. Decisions to take out forward deals would be based on normal investment criteria, as discussed below, albeit taking a slightly longer term view.

3 Investment Principles and Objectives

3.1 As required by the statutory regulations and the CIPFA Code of Practice on Treasury Management, each year Council approves an Investment Strategy as part of its treasury management arrangements. In particular this sets out criteria to manage the security and liquidity aspects of placing investments with institutions (known as counterparties).

3.2 The main principles governing the Council's investment criteria are the security and liquidity of its investments before yield, although the yield or return on investment will also be a consideration, subject to adequate security and liquidity. This is in line with Government guidance on Local Government Investments, which also states that *"it will be appropriate to seek the highest rate of return consistent with the proper levels of security and liquidity".*

To help understanding of the above statements:

Security: relates to how safe an investment is, i.e. how reliable is the institution in which money is invested

Liquidity: relates to cash flow, i.e. making sure investments are flexible enough to avoid unnecessary cash flow difficulties

Return: typically the interest made on investments

3.3 Given the nature of the concerns raised, more information regarding the security aspects is provided in the section below.

4 Security of Investments

4.1 As set out in the attached Strategy extract at ***Appendix A***, the security of investments is managed through using credit ratings; this element of the Strategy has remained broadly the same for the last few years or so. There are three main agencies – Fitch, Moody's and Standard and Poor's. The ratings given by each agency differ in range and terminology, however, and so for consistency the Investment Strategy refers to Fitch ratings.

4.2 It should be noted that financial institutions invite the agencies to rate their organisations, so if one is not rated by all agencies it does not necessarily preclude it from being on the Council's counterparty list. For the three Icelandic Institutions, they all had Fitch and Moody's ratings but only one (Glitnir) had Standard and Poor's.

4.3 Each agency covers various criteria in determining its ratings and these are reviewed regularly. More information on this will be included in the presentation but a summary of the ratings and their movements for the Icelandic banks is included at ***Appendix B***.

4.4 As touched on in section 2.2 above, under the Investment Strategy investments can be placed for a future date, i.e. an investment could be agreed (or 'traded') today with a start date of 01 April 2009, providing that the chosen institution's credit ratings are sound and that the investment would not cause any foreseen difficulties with cashflow. The main reason for considering such forward deals is to provide some degree of certainty with regard to future returns, as there can be much uncertainty in future movements in interest rates and sometimes, on balance, it can be viewed better to lock into future agreements rather than keep all investments short.

4.5 For any investment, on the day of trading the Council enters into a contractual obligation to transfer the money to the financial institution concerned, irrespective of what its credit rating may be on the actual date of transfer. Whilst there is, therefore, more potential risk attached to forward deals and longer term investments because of the timescales involved (through more scope for ratings changes over that time), generally the credit ratings used are such that a minor downgrading should not affect the full receipt of principal and interest – again this is provided for with the Strategy. The ratings should give the Council sufficient comfort as to the long term stability of the institution.

4.6 Generally, in its portfolio the Council would hold a mix of fixed term short dated investments, longer dated investments, forward deals and also monies in 'call accounts', where deposits can be recalled at any time and so are not fixed for a term. The mix would depend on cash flow needs, interest rate prospects and budgetary considerations. The security of investments would be managed through the ratings attached to the counterparties involved.

4.7 Regarding Icelandic institutions, the Council has used them on around 20 other separate occasions since 2006/07, generating investment interest of approximately £544K.

5 Issues relating to the KSF Investment

5.1 Specific concerns have been raised regarding the KSF investment. As can be seen from Appendix B, this investment was traded on 15 May 2007 and therefore at that date, the Council entered into a contractual obligation to transfer £2M to the bank on 16 May 2008.

5.2 On 09 May 2008, the bank's credit ratings fell to just below those required under the Investment Strategy and it was removed from the Counterparty list, so that new investments could not be placed with it.

5.3 It was recognised, however, that the Council had an existing contractual commitment to transfer the £2M a week later. Nonetheless advice was still sought from Butlers, who confirmed the contractual obligation. Given the relatively minor reduction in ratings, the view at that time was that there was no significant risk to the Council, and so the investment was duly placed. At that time, there were relatively positive articles in the press ("Icelandic banks come in from cold", Financial Times, 11 May 2008) which reported on the banks' first quarter's solid results and indicated some evidence that they were basically sound, though potentially they had been subject to various misconceptions surrounding their funding positions. There can be much speculation in the press and media, but under the Council's Investment Strategy reliance is placed on the credit ratings from the agencies, based on them undertaking objective assessments of counterparties and factoring the results into their ratings.

5.4 It was not until 30 September that the bank's ratings plummeted, and it failed very shortly afterwards. In May, there was no information to warrant breaching the investment contract with KSF, as it was expected then that the bank would continue to trade and therefore would have taken legal action against the Council had the forward deal not been placed. Furthermore the Council's reputation also must be considered. The Council needs to be in a position of trust with other counterparties in order to place investments and gain favourable rates; it is felt that this would not have been the case if the contract with KSF had been breached and legal action had ensued.

6 Monitoring of Treasury Management Activities

6.1 Under the Council's Treasury Management framework, quarterly monitoring reports are submitted through Performance Review Team (PRT) meetings, and an annual report is submitted (via Cabinet) to Council.

6.2 An update on the investment position was included in Financial Services' Quarter 1 PRT and the Investment Register at that date is included at ***Appendix C*** for information. The following was also reported at that time, in respect of the counterparty list:

> "Changes to the list have been more frequent than usual over recent months, as more and more financial institutions have encountered trading difficulties. There have been instances where counterparties have been downgraded, or even removed from the list, during the lifetime of an individual investment. Where applicable to current investments, these are highlighted on [Appendix C to this report]. Given that the underlying criteria behind the list are extremely robust, making it sensitive to even minor changes, it is felt that this has not resulted in any materially increased risk to the Council so far, but the position will continue to be monitored. As a further mitigation measure, no forward deals are currently being entered into, but this will also be kept under review."

6.3 Given the above, the contractual position regarding investments and the relatively minor changes in credit ratings coming through at that time, it is felt that no further actions could have reasonably been taken other than place the £2M with KSF, as contractually committed to do so.

7 Administration / Receivership Arrangements

7.1 By 08 October 2008 all three institutions were either in administration or receivership and had effectively defaulted on their financial commitments. The Local Government Associated (LGA) has become involved on behalf of councils and on 30 October it sent an update to all affected authorities explaining the latest position. This update is attached at ***Appendix D*** and in essence it reported that:

- UK Administrators (Ernst & Young) had been set up for KSF, and a list of lead creditors had been established to represent all local authority councils. They would report back in mid November with a more detailed assessment of how much authorities might receive and when this could be paid.

– The LGA were in the process of setting up creditor groups for Landsbanki and Glitnir, to work with the Icelandic Receivers.

7.2 With regard to this latter point, on 03 November 2008 the LGA wrote to Councils with interests in Landsbanki and Glitnir, inviting them to an initial meeting with Deloitte and Touche, who are now acting on behalf of the creditors of the banks.

7.3 This is in advance of "informal" meetings of the full creditor committees for each bank, which is due to be held in the week beginning 10 November 2008 in Iceland. The initial meeting will :

- Review information received to date from Deloitte about the administration process, including what ground the first creditor meeting is likely to cover, and any decisions it might take;
- Discuss the composition of the steering committee for each bank, and confirm the local government representatives that will attend the meeting in Iceland;
- Agree a set of common principles that the local authority creditor representatives attending the meeting(s) will need to promote.

7.4 Whilst no City Council representative attended, arrangements have been made to gain feedback from other Lancashire authorities and a further update will fed into the Audit Committee meeting.

7.5 In addition, it can be confirmed that the Council has registered as a creditor for all 3 institutions. Recovery will now be subject to the administrative processes either here in the UK or in Iceland.

8 **Prospects for Recovery**

8.1 The position regarding the £6M of investments placed with Icelandic institutions represents a major but uncertain risk facing the Council and this has been highlighted in the recent Medium Term Financial Strategy (MTFS) update report to Cabinet. The following points can be made though:

- The Government has not guaranteed councils' and other bodies' investments in the way that it has for individuals. Assuming that this does not change, recovery will be through the Administration processes outlined above.

- To the date the banks entered into administration / receivership, the Council was due investment interest of £260K and this too is at risk, as well as the £6M invested. A further £135K was due from October to the end of this financial year, with £23K also due in 2009/10, but it is not expected that these amounts will be recovered. These two latter amounts have been excluded from the MTFS projections reported to Cabinet but this is very much a provisional adjustment and no other losses have been provided for at this stage.

- Until some information is known from the Administrators regarding prospects for amounts recoverable and the timescales involved, it is not possible to make any reasonable estimates of the financial impact overall.

- Guidance is being sought on how the impact will be apportioned between General Fund and the Housing Revenue Account, as this is very unclear.

8.2 The Government has indicated though that it will consider capitalisation applications to allow councils greater flexibility to manage the financial consequences of the banking collapse. This means that authorities could:

- use capital resources such as capital receipts etc, to fund any losses, depending on such resources being available; or
- use borrowing to fund any part of those losses. In effect, this would mean that the Council could finance them over a number of years.

8.3 Whilst it is not known whether the Government will implement a special capitalisation bidding round, arrangements are in hand to submit an initial application in the usual annual application process, which has a deadline of 15 December. This does not commit the Council to a specific course of action; it merely keeps the Council's options open.

8.4 Council Officers will continue to work with the LGA and other councils over the coming weeks to give support to the arrangements for recovery, and any associated developments.

9 Future Reporting Arrangements

9.1 As the matter is so significant, and given that the budget process is currently underway, formal updates will be included in the budget reports on every Cabinet agenda until March. This is in addition to the usual quarterly monitoring referred to earlier, and ensures that all Members are informed of developments and the implications can be taken account of in the budget and planning process. Thereafter, the reporting position can be reviewed in light of progress made. Any key information arising will also be communicated informally in the meantime.

9.2 As a result of recently approved changes to the Council's performance management framework, from Quarter 2 the corporate financial monitoring report (including treasury management) will be considered by Cabinet, and this change is felt timely.

10 Current and Future Investment Arrangements

10.1 In light of the uncertainties in the banking sector, the Head of Financial Services put into place new temporary treasury management arrangements with effect from 06 October 2008. In effect, these now keep any new investments very short, with counterparties being limited to either key British or Irish Institutions, where the Government has guaranteed wholesale deposits (i.e. the type made by local authorities). The likelihood is that over the coming months, there will be little if any need to place new investments, but the current arrangements will remain in place in the current climate.

10.2 As can be seen from the LGA note attached, the Government is undertaking an inquiry into local authority investments and it is expected that further guidance and/or regulation will arise as a result of the banking crisis. Any such changes will be incorporated into the Council's treasury management arrangements for the future.

10.3 Finally, the next internal audit review of treasury management will be undertaken shortly and its scope will be influenced by recent events and any resolutions arising from this Committee meeting.

11 **Options and Options Analysis (including risk assessment)**

This report is for information and no options are put forward.

CONCLUSION OF IMPACT ASSESSMENT **(including Diversity, Human Rights, Community Safety, Sustainability and Rural Proofing)** No implications directly arising.	
FINANCIAL IMPLICATIONS As set out in the report.	
SECTION 151 OFFICER'S COMMENTS This report has been prepared by the s151 Officer.	
LEGAL IMPLICATIONS There are no legal implications directly arising from this report.	
MONITORING OFFICER'S COMMENTS The Monitoring Officer has been consulted and has no further comments.	
BACKGROUND PAPERS Treasury Management Strategy, Investment Strategy, Treasury Management investment documents.	**Contact Officer:** Nadine Muschamp **Telephone: 01524 58**2117 **E-mail:** nmuschamp@lancaster.gov.uk **Ref:**