TONBRIDGE & MALLING BOROUGH COUNCIL

FINANCE and PROPERTY ADVISORY BOARD

20 May 2009

Report of the Director of Finance

Part 1- Public

Matters for Recommendation to Cabinet - Non-Key Decision

1 TREASURY MANAGEMENT – THE EFFECT OF AND RESPONSE TO THE BANKING AND CREDIT CRISIS

An update on the position in respect of our investment with Landsbanki and consideration of the treasury management issues raised by the Treasury Select Committee, the Audit Commission and by CIPFA in response to the banking crisis.

1.1 Background

1.1.1 The banking crisis generally and the failure of the Icelandic Banks in particular prompted the Treasury, the Audit Commission and CIPFA to review the way in which Treasury Management was undertaken in the public sector and to offer advice on what constitutes best practice. The purpose of this report is to identify what now constitutes best practice and to make sure this is embodied in our treasury management operation via our Treasury Management Policy, Treasury Management Strategy Statement and Investment Strategy and our Treasury Management Practices (TMP's).

1.1.2 Copies of the various reports or the relevant extracts from these can be found in the Annexes to this report as follows:

- Treasury Select Committee – Banking Crisis: The impact of the failure of Icelandic banks – Section 4 Charities and local authorities and Conclusions and recommendations **[Annex 1]**.
- CIPFA – Treasury management in local authorities – post Icelandic banks collapse **[Annex 2]**.
- Audit Commission Report - Risk and return – English local authorities and the Icelandic banks **[Annex 3]**.

1.1.3 Before addressing the best practice issues in detail, I should give Members an update on what progress has been made in recovering our defaulted investment from Landsbanki. It is hoped that this helps to set the context in which the best practices will apply.

1.2 Latest position re Landsbanki

1.2.1 In my report to Cabinet on 19 November 2008, I set out the position in respect of the £1m investment with Landsbanki that was due to mature on 30 October 2008. Since then my Exchequer Services Manager has attended a number of Local Government Association (LGA) sponsored creditors meetings and we have been represented at the Icelandic Creditor Committee meetings by local authority representatives and legal representatives.

1.2.2 Unfortunately, there is little concrete news that I can share with members because the moratorium issued by the Icelandic Government in respect of Landsbanki has been extended to November 2009. It is, therefore, unlikely that either we or our representatives on the formal Creditors Committee will know what level of settlement we can expect for some months to come.

1.2.3 Our representatives on the Creditors Committee include the Director of Finance from Kent County Council and I am in regular liaison with her regarding progress. I understand that the legal team engaged by the affected authorities believe that if local authorities can be afforded "preferential creditor" status a substantial proportion, if not all, of their investments can be recovered. The application of that status to UK local authorities seems to be supported by the Icelandic Government, who will need to make legislative changes before it can take effect.

1.2.4 In the context of "best practice" as referred to at 1.1 above and later on in this report, it is worth noting that our investment in Landsbanki was 1 out of 21 and constituted just over 3% of our total investments. I hope this gives Members some reassurance that our approach to risk-spreading in terms of diversity and counter-party limits was well within recommended limits.

1.3 Treasury Select Committee

1.3.1 The relevant extract from the Treasury Select Committee report can be found at **[Annex 1]**. If a full copy of the report is required it can be found at http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/402/40202.htm or obtained from my Exchequer Services Manager. The key references to local authorities can be found at paragraphs 64 to 70. These deal with the issues of expertise, spread of risk, advisors and credit ratings, which have been addressed individually below.

1.3.2 Paragraph 66 makes it clear that "each local authority must make its own decision of how and where best to invest funds and must have regard to the CIPFA Prudential Code for Capital Finance in Local Authorities". It also refers to the "CIPFA Treasury Management Code that each authority should follow". I am able to confirm that our treasury management activities have at all times complied with the Treasury Management Policy adopted by Council in July 2003, the Prudential

Code, the annual Treasury Management Strategy Statement and Investment Strategy and the associated Treasury Management Practices (TMP's).

1.3.3 Reference is also made at paragraph 66 to advice from the LGA that "local authorities should spread their investment risks with 5% or 10% at the very maximum of total investments with one institution or sovereign". Our base counter-party limit for internally managed investment is currently £3m (being slightly less than 10% of our total investments) whilst that for our external fund manager is £5m. We do not operate a sovereign limit at this stage largely because our lending list has contracted to principally those UK banks covered by the UK Government implicit guarantee.

1.3.4 The in-house Treasury Management Team does, however, recognise the need to review these limits and is in the process of doing so within the constraints imposed by practicalities such as:

- the availability of counterparties across AAA rated sovereign states that are willing to take investments of £3m or less; and

- whether the UK sovereign limit should be higher than other states.

1.3.5 The Communities and Local Government Committee (CLG) is to report on the role of private sector advisors in local authority investments as is mentioned at paragraph 67. What has been made abundantly clear since the Icelandic banks failure is that they see their role as one of providing information and not advice, which is the contractual position in our case.

1.3.6 Since the 'collapse', however, it is apparent that our treasury advisor is taking a more positive and pro-active approach to providing information. The lesson to be learnt is that treasury management staff need to treat information from treasury advisors as just one piece of the risk assessment process, along with intelligence gathered from the press, radio, internet, credit ratings, etc.

1.3.7 The wider issue of the extent to which credit ratings were implicated in the banking crisis is to be considered in a future report of the Treasury Select Committee. What seems clear is that greater reliance was placed on these ratings than should have been and that they were often used without the qualifications offered by market intelligence and other forms of information. Our treasury advisor has responded positively to the concerns about reliance on credit ratings by offering a new 'weekly duration rating service' that overlays backward looking credit ratings with forward looking credit default swap information. They are confident that by doing so they will be able to provide clients with early warning of market concerns about individual counter parties.

1.4 CIPFA – Treasury Management Panel Bulletin – Treasury Management in Local Authorities – Post Icelandic Banks Collapse

1.4.1 The interim advice issued by CIPFA in advance of the publication of a revised Treasury Management Code and guidance notes later this year, are more detailed than the Treasury Select Committee report but, as might be expected, overlap to some degree. Current practice and or intended actions in response to each of the key areas mentioned in the Bulletin are set out in succeeding paragraphs.

1.4.2 Diversification across countries, sectors, counter-parties and instruments is identified as a key consideration in setting treasury management objectives. We have recognised this need and review our exposure via the Specified and Non-specified Investments appended to our annual Treasury Management Strategy Statement and Investment Strategy. The continued use of an external fund manager provides access to greater expertise and range of financial instruments such as CDs, Gilts and Eurobonds issued by the highest quality counter parties of AAA rated sovereign states.

1.4.3 Members may recall that, in 2006, the decision was taken to reduce the amount of funds managed externally because of poor returns. Whilst that decision may have proved correct in terms of return expectations, it is now evident that the use of fixed term investments for those core and cash flow investments managed internally posed a greater risk than was known at the time. In recognition of this fact the in-house Treasury Management Team decided, in October 2008, to move all cash flow investment of longer than 3 months and all internally managed core funds on maturity to our external fund manager for investment in tradable instruments such as CDs, Gilts, Eurobonds, etc.

1.4.4 Although our governance arrangements for treasury management are consistent with CIPFA advice there is a need to develop a greater understanding of treasury risks within our organisation. As a first step, a seminar on Credit Worthiness has been organised for officers and key members on 28 May 2009. This can be supplemented by the member training package that CIPFA is looking to develop later this year. It is also proposed to report on treasury management activities in more detail in the future and to include the Audit Committee in that reporting process. A list of our investments as at 7 May 2009 is given at **[Annex 4]**.

1.4.5 Our counter-party list is kept under continuous review in the light of information gathered from the strengthened weekly duration matrix and credit rating updates issued by our treasury advisor and market intelligence gathered from a number of sources, e.g. brokers daily commentary, Financial Times. As is mentioned at 1.3.3 above the setting of counter-party, group, sector and country limits is being reviewed by the in-house Treasury Management Team.

1.4.6 The issues concerning the role of treasury management advisers are addressed at paragraph 1.3.4 above and do not need to be repeated. Perhaps the question that needs to be asked is: do we receive value for money for the information service that we are currently contracted to receive? My answer to that question would be yes - provided we use the information as just one part of the decision making process. I am perhaps comforted by what I perceive to be a more proactive response from our advisors 'post Iceland' and their efforts to strengthen their duration matrix.

1.5 Audit Commission - Risk and Return – English Local Authorities and the Icelandic Banks

1.5.1 The Audit Commission report looks at treasury management in local authorities and recognises that there are strengths and weaknesses as within its own organisation. On the whole, the Commission found that the majority of councils acted properly in managing their investments. This Council was amongst those that had been found to have acted properly.

1.5.2 There is much of value in the report, but the key issues appear to me to be those set out in the Recommendations on page 6. I have, therefore, addressed these individually in succeeding paragraphs, albeit in some cases by reference back to my response to earlier paragraphs of this report where the same issues were addressed in connection with the Treasury Select Committee or CIPFA.

1.5.3 The issues of risk appetite and capability are largely addressed through the adoption of the annual Treasury Management strategy Statement and Investment Strategy. These set out in detail the range of investment options and the degree of risk acceptance. The Specified and Non-specified Investment Appendices to the Strategy reflect the expertise of our in-house team by limiting their options to fixed term investments. As we now know this was in itself a risk and is one that has been addressed by our intention to move funds to our external fund manager for investment in tradable instruments.

1.5.4 We do indeed follow the CIPFA Code of Practice and ensure that treasury management policies are scrutinised at Cabinet and Council. As was mentioned earlier in respect of reporting/monitoring **it is proposed to extend the reporting process to the Audit Committee and in so doing ensure that members are regularly updated on the Council's investment activity**.

1.5.5 The treasury management function in an authority of our size forms part of the duties of one or two key staff members who have attended treasury management training courses and regularly attend treasury seminars. Prior to the banking crisis it was considered to be appropriately resourced commensurate with the risks involved. It was also considered that the staff had the right skills and access to sufficient external information. Our reaction to the Icelandic banks failures and subsequent market volatility prompted a review of those arrangements and resulted in the following changes to the investment process:

- In order to mitigate the increased risk of default in the event of bank failure, internally managed fixed term core funds are to be transferred to the external fund manager upon maturity;

- Investments of longer than three months are also to be transferred to the external fund manager for the reason set out above;

- Overnight investments must now be authorised in advance by one from Chief Executive, Director of Finance and Chief Accountant. If authorisation is not possible funds are to remain on the Council's current account with Nat West; and

- Investments for longer than overnight must now be authorised in advance by two of the officers identified above acting in concert.

1.5.6 The training of elected members so that they are more able to scrutinise effectively and be accountable for the treasury management function may need to be further considered following the Credit Worthiness Seminar that will take place on 28 May 2009 and is to be attended by key members and officers.

1.5.7 It could be argued that the use of an external fund manager in conjunction with the in-house team is the optimum spread of risk and return, particularly as is mentioned at 1.5.4 above, the in-house team are to focus only on fixed term investments of less than three months and the fund manager invests mainly in tradable instruments. As we are debt free the early repayment of loans or borrowing money ahead of need are not relevant to us.

1.5.8 Using the fullest range of information before deciding where to deposit funds, being clear about the role of external advisors and recognising that local authorities remain accountable for decisions made are issues that have been addressed earlier in this report. Suffice to repeat that we are now more clearly aware that our adviser merely provides information which can be used in conjunction with information obtained from other sources to inform our decision.

1.5.9 The sharing of resources in order to gain economies of scale clearly applies to our use of an external fund manager and possibly to the use of money market funds. Whether such economies can be achieved or better achieved by sharing with other local authorities is open to question. It is my intention to raise this with my fellow professionals at a future meeting of the Kent Financial Officers Association.

1.6 Legal Implications

1.6.1 The contract with Landsbanki remains in default. The Council is registered as a creditor and is taking action via the Creditors Committee sponsored by the LGA, by the representatives of that Committee who have been appointed to serve on the Icelandic Creditors Committee and by externally appointed legal advisers.

1.7 Financial and Value for Money Considerations

1.7.1 The degree to which the deposit of £1m with the Icelandic Bank, Landsbanki will be repaid and when will not be known before November 2009. There are no significant cash flow issues arising from the default.

1.7.2 Costs incurred by the Creditors Committee representatives and the external legal advisers are to be apportioned pro rata to exposure to Icelandic banks, they should not prove to be significant and can be accommodated within existing budgets.

1.8 Risk Assessment

1.8.1 This report identifies where processes can or have been strengthened to further protect the Council's interests.

1.9 Recommendations

1.9.1 Members are RECOMMENDED to note the findings of the effect and response to the banking crisis of the three bodies referred to in this report.

1.9.2 Members are also RECOMMENDED to note and endorse the measures taken in response to the banking crisis detailed in this report.

Background papers: contact: John Pickup

Treasury Select Committee report - Banking Crisis: The impact of failure of the Icelandic banks.
CIPFA Treasury Management Panel Bulletin – Treasury Management in Local Authorities – Post Icelandic Banks Collapse.
Audit Commission – Risk and return – English local authorities and the Icelandic banks.

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