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OXFORD CITY COUNCIL

To: **City Executive Board/Council**

Date: **20th October/15th December 2008** **Item No:**

Report of: **Head of Finance**

Title of Report: **Treasury Management Issues following collapse of Icelandic Banks**

<u>**Summary and Recommendations**</u>

Purpose of report: The purpose of this report is to update the Board on the current financial position of the Council following the demise of the Icelandic Banks, how this has affected the Council and how to take forward future investment decisions.

Key decision? No

Executive lead member: Councillor Ed Turner

Report Approved by:
Finance: Jeremy Thomas
Legal: Sarah Fogden

Policy Framework: Sustaining Financial Stability/Treasury Management Strategy

Recommendation(s):
That the action being taken under the current Treasury Management Strategy to ensure compliance with the CIPFA code of Practice on Treasury Management and maintaining the best level of security on our investments in the current financial climate be noted, and that the appropriate changes to the Treasury Management Strategy be recommended to Council on 15th December.

Introduction

1. On Tuesday 7th October 2008 Icelandic Banks became the latest victim of the Credit Crunch, and as of that date Landsbanki and Glitnir were put into receivership and Heritable Bank Plc and Kaupthing Singer & Frielander Limited were taken into administration

2. Ernst and Young have been called in as administrators for Heritable Bank Plc and Kaupthing Singer & Frielander Limited, all accounts were immediately frozen for these banks.

3. The Icelandic Government have installed a team to run Landsbanki and Glitnir, but all accounts have also been frozen.

4. Any maturities in the immediate term will not be repaid, due to all accounts being frozen. This does not mean that we will not get our money back at some point in the future. The administrators and receivers are assessing the assets that are held, and whether they can be sold off to repay all, or part, of the deposits held.

5. We currently have funds with Heritable Bank Plc and Glitnir as follows:

Counterparty	**£**	**Start date**	**Maturity date**
Glitnir	1,500,000	04/02/2008	28/01/2009
Heritable	1,000,000	05/06/2008	05/01/2009
Heritable	1,000,000	25/07/2008	30/04/2009
Heritable	1,000,000	05/09/2008	09/12/2008

6. The latest information shows that 116 councils have been affected, of which they are known to have deposits in Icelandic banks amounting to £858.3m.

7. Our approved counterparty list determines who we can lend money to, this is based on credit ratings for banks and asset base for building societies. This has been changing on a daily basis, and has shrunk by about 25% in the last few months. This has led to the situation where we have money lent out to institutions that have now been removed from our counterparty list. In addition to the money with Icelandic banks detailed above we have a further £1,000,000 with institutions no longer on our list. This money is with Cheshire Building Society, who have been removed from our list due to their rates being downgrading during their merger being finalised with Nationwide. This merger is due to complete on the 1st December 2008 at which date Cheshire will cease to exist. This investment is due for repayment on 27th November 08.

8. Landsbanki and Glitnir were removed from our Counterparty list on 20th March 2008 following the financial strength being lowered to below our minimum criteria.

9. Kaupthing Singer & Frielander Limited were removed from our Counterparty list on 13th May 2008 following the downgrade of all their ratings by Fitch.

10. Heritable Bank Plc remained on our Counterparty list until 30th September 2008. They had a Negative Rating Watch put on them on

the 1st April 2008 but this was removed on the 9th May 2008, therefore remaining on our list, until they were downgraded on the 30th September.

Likely impact on the Council

11. We are working with the Government through the Local Government Association to try to recover this money from the banks' administrators. While the LGA is making reassuring noises it is impossible, at this point, to know what the outcome of these negotiations will be. In these circumstances, we have no responsible option but to plan for the worst case possible.

12. Appendix B show the latest press release from the LGA which gives the latest position.

13. This means that - while we can manage our cash flow and pay wages - the Council will need this year to write off this investment in its accounts. The Council currently has a general fund balance of £3M. If we were to take no action we would have a deficit of £1.5M after the write down. We are under a statutory obligation not to let this happen and we will need to quickly rebuild balances.

14. The Wider Leadership Team have reviewed the financial prospects and agreed to explore the possibility of pausing discretionary spend – where this does not cause immediate damage to services and customers. Other actions being reviewed to rebuild balances are:

    - Directors and Service Heads will carry out a line-by-line budget review in order to drive out budgets that will not be spent in the current year. This includes both revenue and capital budgets
    - The Heads of Finance, working with Service Heads, will identify any project or salary expenditure capable of capitalisation
    - The Heads of Finance, working with Service Heads, will review funds to see if any could be released to the General Fund, eg: insurance, renewals, repairs and funds for projects.
    - Finance will review the Capital Programme funding to identify whether any capital receipts being used to fund decent homes could be used to fund general fund capitalisation in the short term.

15. These reviews will take place over the next 3 weeks with the aim of providing a further report on the Council's financial prospects in mid/late November

Changes to Treasury Management Strategy

16. Following the events above we have needed to re consider our future investments and how we would like to place them to ensure security of our funds.

17. We do not deal on a daily basis, but have three particularly busy days a month, when we receive grant money and CT and NNDR receipts. On these days we may have to lend upto £5,000,000. On other quieter days it can be £1,000,000 or £2,000,000, but not every day.

18. When placing investments we consider risk and return, but recent events have highlighted that risk is predominantly more important in the current climate.

19. We have different options to consider when we are looking at the risks we are taking. The safest of our options is to invest with the Debt Management Office (DMO), the middle of the road option would be to invest with Money Market Funds (MMFs), and the final option would be to invest on the market. All of these options are safe, and all meet our criteria for lending, but have different degrees of security. The degrees of security are offset against the interest rates that they offer, the highest level of security offer the lowest interest rate, this is with the DMO. The table below shows how much the interest that we can earn can be affected through the different options. The figures are based on an investment of £1,000,000 over different periods.

	DMO	MMF
1 Month Rates	4.40%	5.60%
Money market 1 month rate	6.10%	
Difference to Money market rate	**1.70%**	**0.50%**
Difference of interest based on £1,000,000 per month	1,397	411
Difference of interest based on £1,000,000 for six months	8,523	2,507
Difference of interest based on £1,000,000 per annum	17,000	5,000

20. If we chose to invest all of our money to the DMO, we would, in effect, be losing 1.7% of our interest, this equates to approximately £680,000 per year. Based on this it would be in our best interests to use a mixture of the three options, and therefore increase our interest earned figures, whilst maintaining a good balance of risk.

21. We will continue to have a risk averse attitude to our investments but whilst continually looking for the best interest to be earned in that environment. This will include utilising MMFs and Northern Rock in the short term.

22. We are looking to re consider our current counterparty list, in the short term, and to limit our risks. We would like to restrict our list to UK banks and the top 15 UK Building Societies, Irish Institutions, Debt Management Office (DMO) and Money Market Funds (MMF).

23. We have also implemented additional procedural practices to ensure that no one officer is responsible for making investments and that more frequent meetings are held to discuss our strategy.

Irish Institutions

24. The Irish Government has put in place, with immediate effect, a guarantee arrangement to safeguard all deposits, covered bonds, senior debt and dated subordinated debt with the following banks: Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society (EBS). It has done so following advice from the Governor of the Central Bank and the Financial Regulator about the impact of the recent international market turmoil on the Irish Banking system. The guarantee is being provided at a charge to the institutions concerned and will be subject to specific terms and conditions so that the taxpayers interest can be protected.

25. The guarantee will cover all existing investments, and any new ones made after the 29th Sept 2008. This guarantee expires on the 28th Sept 2010.

26. The Governments objective in taking this decisive action is to maintain financial stability for the benefit of depositors and businesses and is in the best interests of the Irish economy.

27. We currently have £11,500,000 invested with Irish Institutions, this is less than 25% of our total investments, and we intend to keep the total of investment with Irish institutions within this limit.

28. It is recommended that some longer term deals with banks, over three months, that we do should be done with Irish institutions, as long as they will fall within the guarantee.

UK Building Societies

29. Our current Treasury Management strategy states that all Building Societies with an asset base of over £500m or that meet our minimum credit criteria (Fitch F1/A-, Moody’s P1/A3, S&P A1/A-) will be added to our Counterparty list. If a Building Society has credit ratings the limits are based on those, but if they don’t then the limits are based on their asset base.

30. An asset base of between £500m and £2,000m will have a limit of £2,500,000 upto 183 days and an asset base of over £2,000m will have a limit of £5,000,000 upto 364 days.

31. In the short term we have considered our options and would like to remain active with UK Building Societies and to allow us to do this with minimum risk, we would propose only using those Building Societies with an asset base of over £3,000m, but still keeping the limits based on credit ratings or asset bases.

32. The Building Society Association has confirmed that the total investments of Building Societies in the Icelandic banks is less than £200m, which is only 0.05% of their total assets.

33. The Building Societies that we would like to continue to invest with are listed in the table below:

Counterparty	Asset Base*	FITCH				MOODY'S			S&P	
		ST	LT	I	S	ST	LT	FS	ST	LT
Nationwide Building Society+	138,637,600,000	F1+	AA-	A/B	2	P1	Aa2	B	A1	A+
Yorkshire Building Society	23,136,924,000	F1	A	B	3	P1	A2	C	A1	A
Coventry Building Society	14,908,400,000	F1	A	B	3	P1	A2	C+	-	-
Chelsea Building Society	13,016,951,000	F1	A	B	3	P1	A2	C	-	-
Skipton Building Society	11,966,998,000	F1	A	B	3	P1	A2	C+	-	-
Leeds Building Society	91,992,000,000	F1	A	B	3	P1	A2	C+	-	-
Principality Building Society	5,825,958,000	F1	A-	B/C	3	P1	A2	C	-	-
Norwich & Peterborough Building Society	4,309,548,000	-	-	-	3	P1	A2	C	-	-
Stroud & Swindon Building Society	3,156,109,000	-	-	-	-	-	-	-	-	-
Nottingham Building Society	3,024,462,000	-	-	-	-	-	-	-	-	-

* Figures for year ended 31st March 2008

+ Nationwide is merging with Derbyshire and Cheshire from 1st December 2008. Both Derbyshire and Cheshire will cease to exist

UK Banks

34. The Government, after consultation with the Bank of England and the Financial Services Authority, have announced that it is bringing forward specific and comprehensive measures to ensure the stability of the financial system and to protect ordinary savers, depositors, businesses and borrowers.

35. It proposes to:
    - Provide sufficient liquidity in the short term
    - Make available new capital to UK banks and building societies to strengthen their resources permitting them to restructure their finances, while maintaining their support for the real economy; and
    - Ensure that the banking system has the funds necessary to maintain lending in the medium term.

36. At least £200bn will be made available to banks under the Special Liquidity Scheme. Until markets stabilise, the Bank will continue to conduct auctions to lend sterling for three months, and also US dollars for one week, against extended collateral.

37. The following banks and largest building society have confirmed their participation in a Government-supported recapitalisation scheme:
    - Abbey
    - Barclays

- HBOS
- HSBC Bank plc
- Lloyds TSB
- Nationwide Building Society
- Royal Bank of Scotland
- Standard Chartered

38. These institutions have committed to the Government that they will increase their total Tier 1 capital by £25bn.

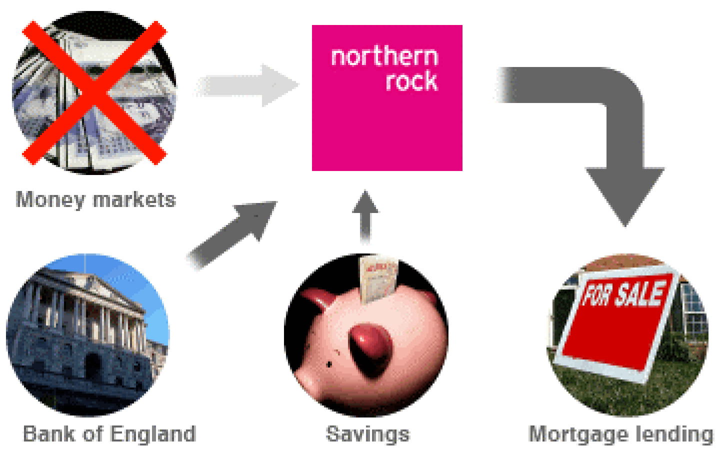
39. Those institutions listed above will also be covered by a guarantee scheme announced by the Treasury on the 13th October 2008. This guarantee scheme is a capitalisation scheme and is providing lending between banks, and will be provided by HM Treasury directly. It will be temporary, covering new lending issued during a six month period, but this period is renewable. This scheme is not a full guarantee of all banks.

40. Following this guarantee we have included these UK banks on our revised counterparty list.

Northern Rock

41. Northern Rock was Britain's fifth largest mortgage lender and was hit hard by the sub-prime crisis in the summer of 2007. Unlike most Banks, who got their money from customers making deposits into saving accounts, Northern Rock is built around its mortgage business. It raises most of the money it provides for mortgages via the wholesale credit market – primarily from selling the debt on in the form of bonds.

42. Following the widespread losses made by investors in loans to US homebuyers with poor credit history, banks and investors who have had their fingers burned have become wary of buying any mortgage debt. This meant that Northern Rock was not getting the inflow of money that it was used to and that it needed to keep its businesses going.



Mortgage lending Northern Rock lends a large amount for mortgages, and finances this with money from banks and savers

Savings Northern Rock receives a relatively small amount of money from savers

Money markets Have stopped lending money to Northern Rock due to the crisis in the US sub-prime mortgage market

Bank of England Steps into the breach to give Northern Rock an emergency loan

43. This resulted in Northern Rock having to ask the Bank of England for emergency funding, which amounted to £26 billion of taxpayers' money. However, the FSA has stated that Northern Rock is a good-quality company that exceeds its capital requirements. It was liquidity issues not solvency issues that caused these problems for the bank.

44. The problems with Northern Rock first came to light on 14th August 2007, when Mervyn King, Governor of the Bank of England, was first alerted. On 16th August Northern Rock enquired about the possibility of finding a private-sector buyer and support. On 14th September Northern Rock confirmed that they had the emergency funding from the Bank of England and this prompted customers to withdraw nearly £2 billion worth of savings over a two-day period (Friday 14th and Saturday 15th September). The government announced on 17th September, that all deposits with Northern Rock would be guaranteed. An announcement on 18th December confirms the guarantee has been extended, at the request of Northern Rock, to cover a wider range of their wholesale products. This includes all existing obligations and any arising in the future. The government must give no less than 3 months notice to withdraw this guarantee. On 17th February 2008 the Government announced that after months of searching for a private-sector buyer Northern Rock was to be placed in a "temporary period of public ownership" (or nationalised in the short-term).

45. Northern Rock has confirmed that as at the 30th Sept 08 £11.4bn of the loan from the Bank of England was still outstanding.

46. Northern Rock are currently active in the market and are offering rates at the lower end of the market. As a comparator Irish Institutions were offering rates of 6.40% in the 3-month period and Northern Rock were offering rates of 6.20% for the same period. This is the maximum period in which we would look to invest with Northern Rock as this coincides with the notice period that the Government have to give before withdrawing their guarantee

47. The current credit ratings for Northern Rock are

Agency	**Northern Rock rating**	**Councils minimum criteria**	**Comments**
Fitch	F1+/A-	F1/A-	Exceed the criteria in the short term
Moody's	P1/A2	P1/A3	Exceed the criteria in

			the short term
Standard and Poor's	A1/A	A1/A-	Exceed the criteria in the short term
Individual rating	F	C	

48. Northern Rock are not currently on our Counterparty list as they do not meet all of our criteria, and we work on a basis that each Counterparty must, but taking into account that they meet our short term rating criteria and they have a full guarantee from the Government for at least three months, we would like to add them to our Counterparty list

Money Market Funds

49. Money Market Funds (MMF) are open ended investment funds that represent vast pools of liquidity invested by a manager in a very wide range of money market instruments. The type and maturity distribution of these instruments is controlled and monitored by the official rating agencies and are key criteria upon which the funds are assigned their rating.

50. Strict rules and criteria are set down by the rating agencies. This will cover important issues such as the type of investment counterparty used, the maturity distribution of funds and investment concentrations. These guidelines ensure a AAA rating.

51. Funds are invested in a wide range of top quality counterparties thereby minimising default risk

52. The manager limits its exposure to any one counterparty to a maximum of between 5% and 10% of the total value of the fund

53. Limits are imposed upon the maximum average maturity of the fund, the decision resting on the rating agency

54. Units are held by a custodian, ensuring there is no direct exposure to the underlying investment. This means that the authority's funds are ring fenced from the operator who will be unable to use them to support its business in the event of difficulties.

55. We currently have one MMF held with Standard Life Investments, and we use this on a regular basis. The rates change on a daily basis but are currently around 5.55%, and are looking to open two further MMFs in the very near future, so that we can obtain a better spread of risk and a better scope on return.

56. Following the recent Council Approval we can now invest upto £10m in total with MMFs, and would like to utilise this facility as much as possible.

57. One of the advantages of a MMF is that the money is liquid and can be withdrawn with no notice, therefore if problems arise we can withdraw all our funds immediately, or within 24 hours.

Debt Management Office

58. Debt Management Office (DMO) are part of the Treasury, and as such are very secure. The downside to the security is the lower rate that is offered, this is currently 4.30% in one month.

59. We currently have a maximum limit for deposits of £8m, but to ensure security for our investments we may want to utilise this account to a greater degree, therefore would like to increase our limit to £20m.

Conclusion and Recommendations

60. Appendix A shows the revised Counterparty list that we would like to start using with immediate effect. We intend to use this until 31st March 2009. After which date the 2009/10 strategy will have been approved and a further counterparty list approved.

61. The intention is to maintain an adequate mix of risk and reward in all our future investments, and to enable us to do this we would like to use UK Banks and Building Societies, Money Market Funds, Irish Institutions and DMO, within the limits set out in Appendix A.

62. We have also implemented some further limitations to this list, they are:
    - Maximum of 20% of total investments with any one counterparty
    - Maximum of 25% of total investments with Irish institutions
    - Maximum of 10% of total investments with institutions in all other countries.

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Background papers:
TM Strategy 08/09 – EB 4th Feb08
TM Annual report 07/08 – CEB 3rd Sept 08

OXFORD CITY COUNCIL LENDING LIST

2008/2009

APPENDIX A

Institution	Group	Max Limit £M's	Max Period (days)	BUILDING SOCIETIES Assets £000's	UK Asset Ranking	CREDIT RATINGS: Fitch Short	Fitch Long	Fitch Indvi.	Fitch Supp	Moody's Short	Moody's Long	Moody's Fin.St	S & P Short	S & P Long
UK														
Abbey National Plc	BSCH Group	7.0	364			F1+	AA-	B	1	P1	Aa3	C+	A1+	AA
Alliance & Leicester	BSCH Group	**See Abbey National for Limits**				F1+	AA-	B/C	1	P1	A1	C+	A1+	AA
Allied Irish Bank (GB)	Allied Irish Bank Plc	**See Allied Irish Bank for Limits**				F1+	AA-	B	1	-	-	-	A1	A+
Bank of Scotland (Ireland)	HBOS Group	**See Bank of Scotland Plc for Limits**				-	-	-	-	-	-	-	-	-
Bank of Scotland Plc	HBOS Group	10.0	>364			F1+	AA	B	1	P1	Aa1	B	A1+	AA-
Barclays Bank		10.0	> 364			F1+	AA	A/B	1	P1	Aa1	B	A1+	AA
Chelsea Building Society		7.0	364	13,016,951	5	F1	A	B	3	P1	A2	C	-	-
Clydesdale Bank	NAB Group	10.0	> 364			F1+	AA-	B/C	1	P1	Aa3	B-	A1+	AA-
Co-operative Bank plc		7.0	364			F1	A	B/C	3	P1	A2	C	-	-
Coventry Building Society		7.0	364	14,908,400	4	F1	A	B	3	P1	A2	C+	-	-
Credit Suisse First Boston International	Credit Suisse Group	10.0	> 364			F1+	AA-	-	1	P1	Aa1	-	A1+	AA-
HSBC Bank Plc	HSBC Group	10.0	> 364			F1+	AA	A/B	1	P1	Aa1	B	A1+	AA
Leeds Building Society		7.0	364	9,199,200	7	F1	A	B	3	P1	A2	C+	-	-
Lloyds TSB Bank	Lloyds TSB Group	10.0	> 364			F1+	AA+	A	1	P1	Aaa	B+	A1+	AA
National Westminster Bank	RBOS Group	10.0	> 364			F1+	AA	A/B	1	P1	Aa1	B	A1+	AA-
Nationwide Building Society		7.0	364	138,637,600	1	F1+	AA-	A/B	1	P1	Aa2	B	A1	A+
Northern Rock		7.0	183			F1+	A-	F		P1	A2		A1	A
Norwich & Peterborough Building Society		7.0	364	4,309,548	13	-	-	-	3	P1	A2	C	-	-
Royal Bank of Scotland Plc	RBOS Group	**See Natwest Bank for Limits**				F1+	AA	A/B	1	P1	Aa1	B	A1+	AA-
Skipton Building Society		7.0	364	11,966,998	6	F1	A	B	3	P1	A2	C+	-	-
Stroud & Swindon Building Society		7.0	364	3,156,109	15	-	-	-	-	-	-	-	-	-
Ulster Bank Ireland Ltd	RBOS Group	**See Natwest Bank for Limits**				F1+	AA-	B	1	P1	Aa2	C+	A1+	AA-
Ulster Bank Ltd	RBOS Group	**See Natwest Bank for Limits**				F1+	AA	B	1	P1	Aa2	C+	A1+	AA-
Yorkshire Building Society		7.0	364	23,136,924	3	F1	A	B	3	P1	A2	C	A1	A
IRELAND														
Allied Irish Bank	Allied Irish Bank Plc	7.0	364			F1+	AA-	B	1	P1	Aa2	B-	A1	A+
Anglo Irish Bank Corporation		7.0	364			F1+	A+	B	3	P1	A1	C+	A1	A
Bank of Ireland		7.0	364			F1+	AA-	B	1	P1	Aa2	B-	A1	A+
EBS Building Society		7.0	364	19,502,000	1	F1+	A	B	3	P1	A1	C+	-	-
Irish Permanent Plc		7.0	364			-	-	-	-	P1	Aa3	C+	A1	A
OTHER														
Money Market Funds		10.0	364											
Debt Management Office		20.0	364											

No more than 20% with any counterparty

Country limits to be applied

No limit for UK investments

upto a maximum of 25% of total investment to be with Irish Institutions

upto a maximum of 10% of total investment to be with institutions in other countries