To:	Cabinet – 13 October 2008
By:	Nick Chard, Cabinet Member for Finance Lynda McMullan, Director of Finance
Subject:	TREASURY MANAGEMENT
Classification:	Unrestricted

Summary: To update Members on developments related to the Icelandic banks.

FOR INFORMATION

INTRODUCTION

1. This is an emergency report to update Members on the latest position relating to the investment of KCC cash in the Icelandic Banks.

FINANCIAL CONTROLS

2. All organisations have to manage their cashflow as part of their overall financial management arrangements. The cash arises in a small part from the reserves of the Authority but more significantly from working capital. For example, we will receive precept income and government grant on specific dates known well in advance, this money will then be placed on deposit and receive interest and will then be withdrawn to meet major monthly items such as the payment of staff salaries. Given the size of KCC's revenue and capital balances these sums can be very large, in 2007-08 the average daily balance was £325m. Projections of the interest which will be received are built into KCC's base budget in the Financing Items budget. It must be emphasised that this money is not being "withheld" from services and nor is the interest received a "surplus" it actually supports the base budget and keeps down the level of the Council Tax.

3. Overall what local authorities can do with this cash is governed by the CLG Investment Regulations. Post the collapse of BCCI in 1991 local authorities were advised to spread their investments widely. This was reinforced by the 2004 Regulations which apply now and allowed local authorities to invest for longer periods. This is then set out in more detail by the CIPFA Code of Practice on Treasury Management. The whole emphasis of this is that local authorities should protect their principal sum. These have historically been very low risk, prudent investments.

4. The key processes internally are that:

   (1) The Treasury Strategy is agreed annually as part of the budget process by the February budget County Council meeting.

   (2) We report annually to Governance & Audit Committee on our processes and performance; most recently on 17 September.

   (3) The implementation of the strategy is overseen through quarterly meetings of the Treasury Policy Group consisting of the Cabinet Member for Finance, the Director of Finance and the Head of Financial Services.

5. Given the importance of this issue, local authorities contract with one of a small number of treasury advisers. KCC is advised by Butlers who are owned by ICAP and this was last tendered in 2004. A key role of Butlers is to advise on which financial institutions we should use. Officers reviewed the counter party list and the existing deposits with Butlers on 29 September. Our Treasury Management Practices state:

   - *Ratings from the three different credit rating agencies (Moody's, Standard & Poors and Fitch IBCA) used in conjunction with matrices, provided by our financial advisors, provide an evaluation of credit worthiness.*

   - *Our financial advisors have suggested a perspective of an institution's credit worthiness be gained from:*

     – *Long term and short term ratings (the capacity to service and punctually pay senior debt obligations).*

     – *The financial strength/individual rating (the intrinsic soundness of an institution evaluated on a standalone basis)*

     – *Legal rating (the assessment of lender of last resort).*

   In addition:

   - *Institutions should be added to/removed from the approved list according to the following criteria*

   - *Credit rating*
     If any institution on the list no longer meets criteria it must be removed immediately. If an institution not on the list now fulfils the criteria it may be added.

   - *Sovereign rating*
     If the Fitch sovereign rating falls below AA- the institutions for that country must be removed from the list.

In the cold light of day these words now hold no comfort at all but it was an approach which served KCC and other local authorities well until the events of the last few days.

6. In a joint statement from Government and the LGA on 9 October it was stated:

   Government and the LGA agreed that there is no evidence of recklessness by local authorities. They also agreed the financial framework for local authorities, which requires them to strike an appropriate balance between security of investments and returns, appears to have been adhered to.

7. All of our treasury management practices have been adhered to during this period. This area was subject to an internal audit review in 2007 where it received the highest rating, "Substantial". In addition, external audit reviewed this area as part of its normal annual review.

ICELANDIC DEPOSITS

8. As at 7 October KCC had £482m deposited including £16m of Fire Authority funds and £145m of Pension Fund cash. Of the £482m some £50m were with the three institutions affected; 3 investments totalling £15m with Glitnir, 4 investments with Landsbanki totalling £17m and 6 totalling £18m with Heritable Bank. These 13 deposits were made over a period of nearly a year and all were made when the ratings were sound. They were all fixed term deposits and so none of them could have been recalled, even with penalty, without the agreement of the institution.

9. Clearly our concern is for our funds deposited, including the Fire Authority, but it is clear that well over 100 local authorities and other public bodies had deposits currently estimated at some £1bn with these institutions.

10. There is inevitably much being wise after the event but the reality is that given the sums of money involved, local authorities have to have highly controlled processes for making their investments which have to be driven by hard facts which were provided by the rating agencies. Without these controls there would have been scope across councils for maverick behaviour and the consequential possibility of fraud and losses.

11. According to an HM Treasury Statement on 9 October, Landsbanki is in receivership in Iceland and Government have frozen their UK assets. Heritable is a subsidiary of Landsbanki and is in administration in the UK. Glitnir is in receivership in Iceland.

12. A team from HM treasury went gone to Iceland last week. The critical issue now is to establish what assets there are in these institutions which

can be liquidated in a managed way over a period. It should be highlighted that a major reason why they retained their high rating was that they have had no write downs and no exposure to the toxic US housing related debt.

IMPACT ON KCC

13. This is a serious financial issue for KCC but it is manageable. The reason that we have money on long term deposit is that we have longer term commitments. There is no immediate liquidity issue. So there is a clear statement that we can meet staff salaries, payments to suppliers and pension payments.

14. In this report there is no point in speculating on the path to recovering assets but that clearly is the main issue now.

15. The other major issue for us is where we currently have investments placed and we are now reviewing this daily with all new money being placed in the Government Debt Management Office. This has a low interest rate with the consequential impact on KCC's budget.

ACTION BY KCC

16. The actions below have been put in place as a matter of urgency.

17. Currently, with our consultant advisors, we are reviewing all our investments worldwide to continue to minimise risk.

18. KCC has written to the Chancellor of the Exchequer proposing that, moving forward, Government should guarantee local authority deposits with UK banks. This would help repatriate billions of pounds which UK local authorities have invested abroad.

19. A further letter is to be written to the Government seeking their support to treat voluntary sector deposits in the same way as local government.

20. We will ensure we continue to bear down on our procurement and transactional costs

21. We will be in discussion with other public and third sector organisations within Kent to establish any other apparent risks that could compromise local services outside of KCC.

22. The Leader has set up and is chairing an **Economic Management Group** comprising Senior Cabinet Members, the Chief Executive, and Director of Finance to receive and evaluate the decision-making and risks associated with KCC's total investment both within the UK and world wide to ensure that everything possible is being done in the light of international circumstances to reduce financial risks to the Authority

RECOMMENDATION

23. Members are asked to **NOTE** this report.

Nick Chard	Lynda McMullan
Cabinet Member for Finance	Director of Finance