

Responses to Kent Cabinet Scrutiny Committee questions

Cabinet Scrutiny Committee – Questions for Butlers January 2009

- 1. Could you supply us with an explanation of Butlers' group structure; the name of your parent company and other companies in the related field?**

Butlers is an independently managed division of ICAP Securities Limited (registered in England & Wales under company number 5000777) which is part of the ICAP Group. ICAP is authorised and regulated by the Financial Services Authority. A group organogram is enclosed for your information.

- 2. Could you supply us with an explanation of Butlers' physical structure; how many FTE staff do you employ; what are the main areas of expertise / qualifications of your employees engaged in providing treasury management services to local authorities?**

Butlers employs twelve full time staff and three consultants. Five members of the Butlers staff are CIPFA qualified. All members of the Butlers staff are FSA registered. Butlers' client managers have a broad knowledge across key areas including debt management, credit ratings and investments and capital finance.

- 3. To what extent does Butlers' work in advising local authorities involve interfacing with other divisions of the ICAP group of companies, including in relation to credit risk?**

Butlers is an independently managed division of ICAP. There are strict "Chinese Walls" in place between any departments who may be perceived as having a potential conflict of interest.

- 4. How many authorities do you act for? How is your advice tailored to ensure that it is relevant to each particular client?**

Butlers acts for 145 local authority clients. Butlers' service is tailored to the individual needs and the financial situation of each client. The core of Butlers' services is in providing local authorities with capital and finance accounting guidance, strategic treasury management advice, assisting in the development of budget forecasting and advising on interest rate trends over time.

Each client's differing positions are given due consideration to ensure individual aims are met having regard to the client's objectives, strategy, current financial circumstances, assets and liabilities.

As an ancillary service, Butlers is licensed to pass on information published by the three major Ratings Agencies, based on requests

from its clients. This service saves its local authority clients from having to subscribe for Rating Agency information themselves.

- 5. How many of the local authorities that Butlers advises had money invested in Icelandic banks at the time of their collapse? Did any of the authorities you act for withdraw funds from the Icelandic banks prior to their collapse? If so, was such action taken on the advice of Butlers?**

More than 50 of Butlers local authority clients have money invested in Icelandic banks.

The investments in Icelandic banks were term deposits which cannot be broken before the maturity date. Butlers is not aware of any clients withdrawing money prior to its maturity date. Once a deposit is made it is a legally binding commitment.

- 6. When were the Icelandic banking institutions removed from Butlers' approved counterparty lists?**

Butlers does not maintain an approved counterparty list. Butlers does not recommend any particular investment counterparties. It also does not provide assessments of bank creditworthiness beyond an initial assessment of its clients' chosen risk parameters in its approved Annual Investment Strategy (in terms of credit rating) and thereafter the provision of up to date information from the major credit rating agencies. Some local authorities included criteria which permitted investment in Icelandic banks and others did not. As such the Icelandic banking institutions were removed from client lists depending on their individual criteria. Further details of the system are in question 11.

Butlers also sends monthly updated counterparty lists to Kent County Council. Weekly summaries of rating changes are also provided in the Weekly Investment Monitor.

- 7. Could you supply us with a list of the credit rating agencies used by Butlers?**

Butlers supplies information from the three main credit rating agencies, Fitch Ratings Ltd, Moody's Investor Services and Standard and Poor's.

- 8. What is the nature of the relationship between Butlers and the credit rating agencies? Do the credit rating agencies pay you to recommend them to clients and, if so, on what basis?**

Butlers is licensed by the three main credit rating agencies to distribute its ratings. The credit rating agencies do not pay Butlers a fee. Butlers pays a license fee to the credit rating agencies.

The use of credit ratings agencies by local authorities is endorsed by government guidelines. Part of the definition of a Specified Investment (as defined in the Guidance on Local Government Investments issued by the Secretary of State under section 15(1)(a) of the Local Government Act 2003) is that the investment is made with a body or in an investment scheme which has been awarded a high credit rating by a credit rating agency. Credit rating agency is defined as one of the following three companies: Standard and Poor's; Moody's Investors Services Ltd; Fitch Ratings Ltd. The guidance goes on to say that, as part of its Annual Investment Strategy, each local authority should specify how "high credit rating" is to be defined and how often credit ratings are to be monitored.

9. When were you first aware of the risks to the Icelandic banks? To what extent, if any, does Butlers monitor market data such as credit insurance rates in assessing the credit risk of particular counterparties?

Please see the response to question 6.

Butlers provides information on the credit ratings as supplied from the three major and internationally recognised credit rating agencies. A credit rating is an independent assessment of the risk associated with investing with a particular counterparty. A timeline showing changes to the credit ratings of Icelandic banks is attached.

10. What other information sources, in addition to the credit rating agencies, does Butlers refer to in analysing and measuring counterparty risk and how is such information incorporated into the advice provided to local authorities? How, if at all, does Butlers prioritise information received from the various sources?

Please see the response to question 9.

Butlers also provides a Weekly Investment Monitor which contains generic market intelligence. We also provide a Quarterly Economic Bulletin and an Annual Review of economic and market related issues, we attach an article dealing with counterparty issues from January 2008.

11. Please give a detailed explanation of how the Butlers' counterparty service and database system works. In what way is the database system more than simply a system which filters publicly available ratings published by the three credit rating agencies?

Credit ratings are provided by a direct link to all three of the major credit rating agencies. These include short and long term ratings, individual/financial strength ratings and support ratings. If a rating

agency makes a change to its rating, whether that is a negative/positive rating watch or an actual rating change, the system is updated and a notification is sent by email to the local authority informing them of any change relevant to their counterparty list. This includes identifying how the change impacts on their list, i.e. whether in accordance with its Annual Investment Strategy a counterparty should be removed entirely from the counterparty list, or whether there should be a change in the permitted duration of any investment with that counterparty or the monetary limits accredited to an investment with that institution.

The system adopted by Butlers is able to set criteria upon which information is then provided to local authorities based on:

- Credit ratings
- Time limits
- Money limits
- Building society asset size
- Individual institution names
- Country / Country group

A regular list of all counterparties that meet the council's investment credit rating criteria is sent. The council can decide whether this is daily, weekly, or monthly.

Butlers encourages its local authority clients to adopt its 'lowest common denominator' ("LCD") approach to credit ratings, whereby all investment counterparty limits default to the lowest equivalent rating produced by any of the three credit rating agencies. A notification is sent to that local authority detailing that the credit rating has changed and the change to the list.

We also provide, within the Weekly Investment Monitor, a summary of the rating changes in the past week.

It should be noted that publicly available information will not necessarily include all ratings available via the Butlers system. For example, Fitch will only show Short and Long Term ratings. In addition, the use of Butlers system will give notifications of changes which are received via direct feeds from the agency. This is significantly more robust than having a manual system whereby constant vigilance of all three agency websites by officers would be needed.

12. What factors other than the specific agency credit ratings do you consider would be potentially relevant to the Council's consideration of counterparty risk? Have you at any time suggested to the Council any other additional methods it should use to help manage counterparty risk?"

LCD (Lowest Common Denominator) – this is something which has been recommended to all clients for some time. Butlers will notify and

identify if a counterparty is on rating watch. Local authorities can also include group limits.

Please refer to the information provided in Question 10.

Kent County Council under market rules is a professional client. It is understood that Kent County Council has a treasury policy group which meets to discuss treasury issues, potential instruments, treasury strategy, debt monitoring, and quarterly activity reports.

Butlers offers free seminars to its clients. Butlers does not offer investment advice on any particular institution.

13. What is involved in the “constant review” process that you provide to the Council in respect of the credit ratings of counterparties? How frequent are credit risks associated with particular counterparties reviewed and how are the results of such assessments communicated to the Council? How do you determine which investments are prioritised for review?

Butlers provided immediate notification via email of any changes to the credit ratings which affect the institutions on a local authority’s counterparty list, as detailed in the response to question 6 and 11.

The information is provided to a KCC Officer. This is in accordance with the instructions received by Butlers from Kent County Council.

14. Having met with senior Kent County Council staff the day before the collapse of the Icelandic banks, when and how did you become aware of the risk of continuing to invest in Icelandic banks, when did you notify the Council of this, and why was an email alert about the risks to Council investments sent only to a junior member of staff?

Kent County Council was notified of the change to the credit rating for Heritable Bank on 30 September 2008, when the change occurred. The e-mail was sent to a KCC Officer to whom Butlers were instructed to send notifications.

The meeting on 29 September 2008 discussed the review of Kent County Council’s investment parameters for the 2009/2010 Annual Investment Strategy. There was no discussion of individual counterparties (because Butlers does not give advice on specific counterparties so there is never any discussion of such matters at our meetings).

15. Has Butlers (or any other member of the ICAP group of companies) received any form of commission or had any other financial relationship or arrangement with any of the Icelandic banks?

Butlers is independently managed and is completely segregated from ICAP's broking business. ICAP is FSA regulated and this segregation is required by FSA rules. Butlers plays no part in and derives no economic benefit from advising which broker its customers should arrange their deposits through.

We understand the commission rates earned by ICAP's brokerage business are standardised. Of the 144 Butlers customers at the relevant time, less than one-sixth used ICAP for execution with Icelandic banks for the period 1 January to 30 September 2008.

16. Can you define Butler's attitude to country exposure, do you carry out an analysis of country exposure as well as bank risk?

Fitch offer a separate support rating which assesses the willingness and ability of outside support for those organisations. Sovereign ratings can have a direct impact on individual counterparty ratings. An organisation domiciled in a particular country will likely have some exposure to that country, as such a weak sovereign rating will likely be reflected in the ratings of a particular counterparty. As such, a major concern over a sovereign would be expected to be highlighted in this rating category – i.e. if a country was deemed to be unable to help out its financial sector then this should be reflected through the Support rating. Kent County Council received details of the Fitch support ratings.

17. Generally does the Council follow the advice given by you? To what extent do you feel that you have a responsibility to ensure that the Council has acted upon the advice you have given?

Butlers does not monitor the investment activity of its local authority clients. Nor does Butlers give advice on which counterparties investments should be made with. As such, we cannot verify that rating/investment information (via Weekly Investment Monitor) has been acted upon. Decision making will always rest with the each local authority.

18. Reports have stated that during March 2008 there were clear indications of a struggling economy in Iceland, were these reports well founded and what advice was given to the Council on that basis? What steps did you take to ensure the Council acted on any advice you gave?

It is wrong to suggest that the events that occurred in Iceland were apparent and predictable. Local authorities find themselves in the same position in relation to Icelandic banks as many international banks and bondholders, UK banks and building societies, charities and housing associations. Many of these sophisticated institutions have their own comprehensive credit risk departments. The recent events

were extraordinary and the speed and severity of the developments created an unprecedented situation.

Credit rating agencies provide an independent assessment of the risk associated with investing with a particular counterparty. They are well resourced to take into account all the relevant factors, including any necessarily subjective views reported in the financial press, and adopt an impartial analytical view.

Butlers understands that a review of the regulation of the credit rating agencies is being undertaken on a European level.

- 19. The contract between KCC and Butlers states that “Regular forecasts of PWLB rates and imminent changes will be given to the Council, with particular regard to the agreed underlying strategy. Continuous updates on market conditions and trends affected by economic, fiscal and political factors will also be provided”. In light of that statement what advice was given to the Council about the economic situation in Iceland?**

The economic advice highlighted above relates to the background research undertaken to assist in developing forecasts for UK interest rates and the impact this will have upon the Council’s strategies.

- 20. The contract between KCC and Butlers also states that “Places at our regular seminars and training days will be made available to the Council free of charge”. How many training days have been arranged for the Council? How many staff have attended?**

The regular seminars and training days referred to in the contract relate to our regional seminars and training days which are held at various venues in London including our offices. These are normally held at 3 – 6 monthly intervals. The seminars are available to all clients. Kent County Council staff have, in the past, attended these.

A schedule of seminars and attendees from Kent County Council is attached.

- 21. A report has recently been published on the economic situation in Ireland; was any consideration given to a report on Iceland’s financial situation over the past year?**

What is the report? We can then check whether anything similar was produced for Iceland. Please see the responses to the above previous questions.