Response from Head of Financial Services to
Internal Audit - Treasury Management Report on Icelandic Investments
(Exempt report)

Introduction

At the meeting of the Treasury Management Review panel held on 20 January 2009 15 recommendations were proposed within an Internal Audit report conducted on the processes and procedures leading to the Icelandic investments.

The purpose of this report is for the Head of Financial Services to respond to the recommendations contained within the Internal Audit report.

Recommendation 1 :

That the Council places an agreed limit on the amount of money it will invest with the institutions of any one national economy (either parent banks or their subsidiaries) except the British economy.

Head of Financial Services comment:

At the time of the collapse of the "Icelandic Investments" the Council had c.£33m invested in a range of different organisations.

Of the £9m invested with the banks which "Icelandic Investments", only £3m, around 9% was with an Icelandic Bank, this being Landsbanki. The other £6m was invested in UK registered banks albeit with Icelandic parents.

Using the proposed definition on the banks on the current lending list (8 Banks including the Co-Op) only 4 organisations would be considered to be UK banks proper:

- Bank of Scotland;
- Lloyds TSB Bank;
- Barclays Bank;
- Co-operative Bank.

The remaining banks have relationships with the following countries:

Spain
- Abbey National (Banco Santander Central Hispano Group)
- Alliance & Leicester (Banco Santander Central Hispano Group)

Far East
- HSBC Bank plc

Australia
- Clydesdale Bank (National Australia Bank Group)

The current lending limit with any of these organisations is £8m, if this limit was restricted then this would seriously impact upon the Councils ability to place funds. Whilst the rationale behind the recommendation is acknowledged, I would advise that the individual organisation limit is sufficient, given the Council's current lending list.

Recommendation 2

That the Council changes its Treasury Management policy to ensure that all of its counterparties are rated by all three credit rating agencies and that it continues to use lowest common denominator as the basis for admittance to the Council's counterparty list.

Head of Financial Services comment:

Agreed and implemented, this is the case for all of the Counterparties currently on the new lending list approved by Cabinet on 23 October 2008.

However, it is recommended that the only exception to this condition be the Co-op which is only rated by Fitch and Moody's.

Recommendation 3

That the Council reviews and increases the minimum acceptable credit ratings for potential counterparties, taking detailed note of the definitions of each of the credit ratings, and continues to ensure that all credit ratings are used, not just the rating for the type of investment to be made.

Head of Financial Services comment:

Agreed and implemented, at the meeting of Cabinet on 23 October 2008 increased minimum acceptable credit ratings were approved, and the Middle and Lower Limit Category deleted. In addition the restriction was placed to deal only with UK banks. The table below identifies the criteria as follows:

	Fitch	Moody's	Standard & Poors	Money Limit	Time Limit
Upper Limit Category	**F1+/AA-**	**P-1/Aa3**	**A-1+/AA-**	**£8m**	**3 years**
~~**Middle Limit Category**~~	~~**F1/A-**~~	~~**P-1/A3**~~	~~**A-1/A-**~~	~~**£5m**~~	~~**2 years**~~
~~**Lower Limit Category**~~	~~**-**~~	~~**-**~~	~~**-**~~	~~**£3m**~~	~~**364 days**~~
Other Institution Limits	**-**	**-**	**-**	**£8m**	**n/a**

The other institutions relates to the UK Government and other Local Authorities.

The approved recommendation from Cabinet on 23 October is as follows:

"that for the remainder of 2008/09 investments are only placed with UK Banks and Building Societies which are rated in the Upper Limit Category, i.e. those with F1+/AA- rating, along with the UK Government and other Local Authorities. The only exception being small balances of less that £500,000 which are invested within the Council's own bank's Business Premium Account."

It must be noted however, that this now leaves an extremely small lending list of 7 banks excluding the Co-operative.

Recommendation 4

That all changes in policy are reported to Members with explanations, including changes in the counterparty thresholds, and details of the rating definitions are provided for reference.

Head of Financial Services comment:

Agreed

Recommendation 5

That consideration is given to a more stringent policy for investment with subsidiaries which takes account of the credit ratings awarded to the parent body. As a minimum, both the parent and its subsidiary should have credit ratings within the Council's thresholds before an investment will be placed with the subsidiary.

Head of Financial Services comment:

Agreed and Implemented, the credit ratings have been confirmed for both Banco Santander Central Hispano Group, and National Australia Bank Group to be in excess of the minimum criteria. These banks do not however appear on the Council's lending because they are not UK Banks.

Recommendation 6

That the Council has a formal policy for taking account of negative rating watches relating to its listed counterparties, e.g. not investing with any counterparty where the likely change in credit rating (assumed to be by one rating level unless other information available suggests a greater reduction) will remove it from the Council's counterparty list.

Head of Financial Services comment:

Disagree. Of the current 7 banks on the lending list 4 have negative watches applied. It could be argued that this is because of exceptional conditions at present. It is acknowledged however that further economic information needs to be considered when making investment decisions, this appears to be in line with the approach outlined by Butlers.

Recommendation 7

That, where a substantial investment is to be made by the Council – appropriate threshold to be decided – the Council considers making use of the websites of the TMA and of the credit rating agencies to ensure that they have the most up to date information on the creditworthiness of their proposed counterparty (and does not rely solely on e-mail communications from the TMA which will necessarily involve at least a short delay in the communication of information).

Head of Financial Services comment:
Disagree, Butlers have advised that the method of updating the Council of changes in Credit Ratings is automated and therefore the delay if any is extremely limited.

The occasion of the issuing of "negative credit watches" on 1 April 2008 was unfortunate however the rates were later affirmed. Again, I would refer to the proposals awaited from Butlers before any decision is taken in this area.

Recommendation 8

That the actual counterparty list is reported to Members once or twice a year as at a particular date and making it clear that it is under constant review (this will need to be during the exempt part of the meeting). This could most usefully be done at the same time as the counterparty criteria are being considered for approval by Cabinet and Council, e.g. in February when 'The Treasury Management Policy and Strategy Report' is presented and in September when the 'Report on Treasury Management Service and Actual Prudential Indicators' is presented.

Head of Financial Services comment:

Agreed

Recommendation 9

That counterparty lists are examined for compliance with all criteria when they are received - for which an up to date list of the policies influencing the counterparty list will need to be kept, including the most recently approved threshold credit ratings, the decision to use ratings for Building Societies, the policy with regard to subsidiaries, etc. – with a second person looking at the list when it is received as an independent review, with any unusual entries or other queries being raised and addressed immediately. Both the examination and review to be evidenced by signatures

Head of Financial Services comment:

Agreed, however, it should be noted that no investments have ever been placed with an organisation that did not have the necessary credit ratings. This is now a much reduced list in any case compared to the previous criteria.

Recommendation 10

That the policy of using credit ratings for Building Societies is implemented, as intended and reported in September 2006, in order to help maximise the security of the Council's remaining funds.

Head of Financial Services comment:

Currently no building societies have the sufficient credit ratings to appear on the Council's lending list. This is at odds with the approach taken by Wychavon who continue to use the top 10 Building Societies, as ranked by asset size.

I do believe however, that there should be a place on the 2009/10 lending list for UK Building Societies, even though they do not meet the current Upper Category Limit credit quality as approved by Cabinet on 23rd October 2008.

Recommendation 11

That all communications with or received from the Council's Treasury Management advisers are discussed/reviewed at Treasury Management meetings and listed in the minutes with decisions/responses recorded. This should include the counterparty lists.

Head of Financial Services comment:

Agreed

Recommendation 12

That decisions to make advance investment deals are carefully considered and the reasons fully recorded and that decisions take account of the current economic climate, e.g. advance deals should be generally avoided during a period of economic decline but could be advantageous during a period of economic buoyancy.

Head of Financial Services comment:

Agreed, however, it should be noted that the Council does not enter into advance investment deals for speculative reasons it would only be for administrative purposes.

Recommendation 13

That the opportunity is taken to revise the specification for the Council's Treasury Management advisers and to retender the contract for the period starting September 2010 when the current contract will have expired.

Head of Financial Services comment:

Agreed, this is in line with the Council's Contract Standing Orders.

Recommendation 14

That the Council is proactive in establishing and participating in a Local Authority Treasury Management group for Herefordshire and Worcestershire (subject to sufficient interest from the other local authorities).

Head of Financial Services comment:

It is proposed to refer this recommendation to the meeting of the Herefordshire and Worcestershire Treasurers Association that is meeting on 30 January 2009 for discussion.

Recommendation 15

That there is much greater sensitivity to general economic performance built into the Council's Treasury Management Strategy in future so that, for example, the first signs of an economic downturn will trigger a review of credit rating thresholds and ensure that they are tightened.

Head of Financial Services comment:

See response to recommendation 7

Conclusion

The overall findings and recommendations within the Internal Audit report are useful in helping to develop a future strategy for the Council, whilst reiterating that the investments which were made were in line with the Council's approved Treasury Management Strategy.

On 23 October 2008, the Cabinet implemented increased levels of credit ratings on organisations with whom the Council will undertake investments. Due to further reductions in credit quality since that decision the current lending list is now extremely limited. I would like to make the following recommendations in relation to the Council's future lending criteria to be implemented for 2009/10.

Within the recommendations made by Internal Audit was concern surrounding foreign exposure. However, the recommendation did not suggest excluding these banks altogether. I believe that consideration should be given to the of the use of European banks albeit with strict limitation on the total exposure of no more than £3m per country, with a 6 month limit. In addition, these banks would require the same level of credit rating from all three ratings agencies which is currently applied to the UK banks. This would bring a further 9 counterparties onto our lending list.

In relation to the usage of Building Societies, Wychavon continue to use the top 10 as ranked by asset size, this list is as follows:

Rank by Group Assets	Name of Society	Financial Year Ended	Society Assets £m	Group Assets £m (see note *)
1	Nationwide	04 April 2008	178,482	179,027
2	Britannia	31 Dec 2007	32,377	36,827
3	Yorkshire	31 Dec 2007	23,137	20,498
4	Coventry	31 Dec 2007	14,908	14,909
5	Chelsea	31 Dec 2007	13,017	13,087
6	Skipton	31 Dec 2007	11,967	12,531
7	West Bromwich	31 March 2008	8,651	9,602
8	Leeds	31 Dec 2007	9,199	9,181
-	Derbyshire	31 Dec 2007	7,090	7,094
9	Principality	31 Dec 2007	5,826	5,853
-	Cheshire	31 Dec 2007	4,964	4,976
10	Newcastle	31 Dec 2007	4,699	4,816

I would also recommend at this stage that for the 2009/10 Treasury Management Strategy the Council invests to a maximum of £3m those Building Societies with assets in excess of £10bn, and have at least Fitch Ratings of F1 (Short Term), A (Long Term), C (Individual), 3 (Support), whilst limiting investments for 6 months.

This would include the top 6 Building Societies; excluding the Britannia Building Society. However, recognising the comments made in relation to "negative credit watches", any society with such a watch such as the "Skipton" (currently) would not appear on the lending list. This would leave 4 Building Societies, this would bring a welcome addition to the lending list.

It is also proposed that consideration be given to the future use of Money Market Funds.

Wyre Forest District Council
Proposed Lending List 2009/10

Counterparty	Fitch Ratings				Moody's Ratings			S&P Ratings		Limits	
	S. Term	L. Term	Indiv.	Support	S. Term	L. Term	Fin. Stght	S. Term	L. Term	Time	Money
UK Banks											
(*) BANCO SANTANDER CENTRAL HISPANO GROUP											
Abbey National	F1+	AA-	B	1	P-1	Aa3	C+	A-1+	AA	2 yrs	£5m
Alliance & Leicester	F1+	AA-	B/C	1	P-1	Aa3	C+	A-1+	AA	2 yrs	£5m
(*) HSBC GROUP											
HSBC Bank plc	F1+	AA	A/B	1	P-1	Aa1	B	A-1+	AA	2 yrs	£5m
(*) LLOYDS TSB BANKING GROUP											
Lloyds TSB Bank	F1+	AA-	B	1	P-1	Aaa	B+	A-1+	AA-	2 yrs	£5m
Bank of Scotland	F1+	AA-	C	1	P-1	Aa1	B	A-1+	AA-	2 yrs	£5m
(*) NATIONAL AUSTRALIA BANK GROUP											
Clydesdale Bank	F1+	AA-	B/C	1	P-1	Aa3	B-	A-1+	AA-	2 yrs	£5m
Other UK Banks											
Barclays Bank	F1+	AA	B	1	P-1	Aa1	B	A-1+	AA-	2 yrs	£5m
Co-operative Bank	F1	A	B/C	3	P-1	A2	C	n/a	n/a	1 wk	£500k

Counterparty	Fitch Ratings				Asset Size		Limits	
	S. Term	L. Term	Indiv.	Support	£m	Year End	Time	Money
UK Building Societies								
Nationwide Building Society	F1+	AA-	B	1	**178,482**	04/04/08	6 mth	£3m
Yorkshire Building Society	F1	A	B/C	3	**23,137**	31/12/07	6 mth	£3m
Coventry Building Society	F1	A	B	3	**14,908**	31/12/07	6 mth	£3m
Chelsea Building Society	F1	A-	B/C	3	**13,017**	31/12/07	6 mth	£3m

Counterparty	Fitch Ratings				Moody's Ratings			S&P Ratings		Limits	
	S. Term	L. Term	Indiv.	Support	S. Term	L. Term	Fin. Stght	S. Term	L. Term	Time	Money
European Banks											
France											
(*) CREDIT AGRICOLE GROUP											
Calyon	F1+	AA-	C	1	P-1	Aa1	C	A-1+	AA-	3 mth	£3m
Credit Agricole	F1+	AA-	B	1	P-1	Aa1	B	A-1+	AA-	3 mth	£3m
Other French Banks											
BNP Paribus	F1+	AA	A/B	1	P-1	Aa1	B	A-1+	AA+	3 mth	£3m
Credit Lyonnais	F1+	AA-	B/C	1	P-1	Aa1	B-	A-1+	AA-	3 mth	£3m
Societe Generale	F1+	AA	B	1	P-1	Aa2	B-	A-1+	AA-	3 mth	£3m
Italy											
Intesa Sanpaolo	F1+	AA-	B	1	P-1	Aa2	B-	A-1+	AA-	3 mth	£3m
Netherlands											
(*) ING BANK GROUP											
Internationale Nederlanden Bank/ING Bank	F1+	AA	B	1	P-1	Aa2	B-	A-1+	AA	3 mth	£3m
Other Dutch Banks											
Rabobank	F1+	AA+	A	1	P-1	Aaa	B+	A-1+	AAA	3 mth	£3m
Sweden											
Svenska Handelsbanken	F1+	AA-	B	1	P-1	Aa1	B	A-1+	AA-	3 mth	£3m

(*) – Where a bank is part of a group then the total exposure to group will be the same as individual exposure

Treasury Management Report: Icelandic Investments

(Exempt report)

1. Introduction

1.1 In November 2008 Internal Audit at Worcester City Council were asked to carry out an independent examination of the circumstances leading to the potential loss of £9million in investments with three collapsed Icelandic banks. Worcester City Internal Audit are already contracted to carry out internal audit work at Wyre Forest and, hence, were ideally placed to carry out this special audit. This report is the result of that independent examination.

1.2 The objective of the audit was to review the investments in the Icelandic banks, the terms on which the Council's advisers were engaged, and the development of the current Wyre Forest District Council Treasury Management Policy, particularly that of 2006.

1.3 The key control objectives were:

a) To review the terms on which the Council's advisers were engaged to ensure that:

- the process for entering into the agreement accorded with WFDC policies and procedures,
- the terms and conditions are in the interests of WFDC,
- the advisers acted in accordance with the terms of the agreement.

b) To review the controls over the decision to change the Treasury Management Policy in 2006 to ensure that the following actions are documented:

- the events leading up to the decision to change the policy,
- what changes were actually made to the policy,
- the approval process for the amended policy.

c) To review the controls over the 3 outstanding investments with Icelandic banks to ensure that:

- the investments are in accordance with the policy,
- correct procedures for Treasury management investments have been followed,
- the events leading up to the investments are documented.

1.4 The scope and coverage of the audit were limited to:

a) the objectives listed at 1.3 above;

b) the production of a file of evidence supporting these objectives – the audit does not cover any legal actions which may ensue and does not include expert opinion evidence. However, a report has been produced (this report) for the Head of Financial Services containing audit observations, and recommendations have been made to support control issues where appropriate (see Section 5 of this report).

1.5 The Treasury Management system, as operated within the Council's Financial Services, was audited in 2007/08 with the draft report issued in March 2008 and the final, including responses, issued in July 2008.

2. The Icelandic Investments

2.1 This report examines the circumstances leading to three investments made by the Council with three Icelandic banks. These investments are:

- £3 million invested with Landsbanki Islands HF from 1st November 2007 to 30th October 2008;
- £5 million invested with Kaupthing, Singer and Friedlander Ltd, a UK subsidiary of Kaupthing Bank HF, from 2nd April 2008 to 30th October 2008;
- £1 million invested with Heritable Bank Ltd, a UK subsidiary of Landsbanki Islands HF, from 2nd April 2008 to 30th October 2008.

2.2 Less than a month before the investments were due to be redeemed the three banks collapsed:

- Landsbanki was taken over by the Icelandic government on 7th October 2008 and the UK government passed an order freezing all the assets of the bank from 21st October 2008;
- On 8th October 2008 Ernst & Young were appointed as administrators of Kaupthing, Singer and Friedlander Ltd;
- On 7th October 2008 Ernst & Young were appointed as administrators of Heritable Bank Plc.

2.3 Of the total of £9 million invested with the three Icelandic banks at the time of their collapse none has yet been recovered.

N.B. Positive reports have been received from the two UK administrators which shows a surplus of assets against liabilities on the book value of the assets. The position in relation to Landsbanki remains less clear, however, the UK asset freezing team at HM Treasury has frozen assets totalling £4billion.

3. Councils and Other Bodies Affected

3.1 On 7th and 8th October 2008 five banks, three Icelandic banks and the UK subsidiaries of two of these banks, were placed in administration by the Icelandic and UK governments – including the three banks listed above where Wyre Forest District Council had placed investments.

3.2 The collapse of these banks followed a period of unprecedented global turmoil within the banking industry including the collapse of Northern Rock in 2007, which

required UK government support, and the collapse of American banking organisations including Fanny Mae, Freddy Mac, Bear Sterns and Lehman Brothers.

3.3 Wyre Forest District Council was not the only UK Council to have money invested with the Icelandic banks at the time of their collapse. At least 143 Councils had money invested with the Icelandic banks when they collapsed.

3.4 The total amount of money at risk across all of these Councils is over £899 million. Individual amounts at risk range from £50 million down to £1 million.

3.5 At least twenty-four of these Councils had more money invested than Wyre Forest District Council and three Councils had the same amount invested.

3.6 Sixteen other public bodies have also been affected with over £160 million at risk, including a number of police authorities, the Audit Commission, Transport for London, and a small number of NHS bodies.

3.7 In addition at least 49 charities also had money invested with these banks.

3.8 Wyre Forest District Council invests approximately £30m p.a. of which £9million is currently at risk. Three other Councils also have £9m at risk: Cambridge City Council which has portfolio of over £80million, West Oxfordshire District Council, which has £67million invested in money markets, and Wakefield (size of portfolio not known).

3.9 Hence, the following observations, comments and recommendations need to be read in this context: potential losses are not unique to Wyre Forest District Council.

4. Treasury Management Investments: Background

4.1 Local Government Treasury Management activity is governed by the Local Government Act 2003, which permits a Council to invest 'for the purposes of the prudent management of its financial affairs', and the associated Guidance.

4.2 Two aspects of Treasury Management are considered here: the credit ratings issued by credit rating agencies which are central to any Treasury Management policy (at 4.3 below) and Wyre Forest District Council's method of Treasury Management which is briefly described (at 4.4 below).

4.3 Counterparty Credit Ratings

a) A counterparty is a bank or other institution with which the Council may invest its money. Credit ratings are a key element of investment decisions, as they are used in deciding which counterparties involve least risk.

b) The Guidance from the ODPM referred to 'specified investments' as providing 'high security and high liquidity'. It defines them as 'in sterling and with a maturity of no more than a year' with 'bodies or investment schemes with "high credit ratings" ' which have been awarded 'by a credit rating agency'. All three (unredeemed) investments by WFDC were 'specified investments', i.e. short-term investments.

c) The Guidance further states that a Council's strategy is to state how "high credit rating" is to be defined. It also states that by 'credit rating agency' it means one of three companies, i.e. Standard and Poor's, Moody's Investors Service Ltd, and Fitch Ratings Ltd.

d) The credit rating agencies give up to four credit ratings covering different aspects of the proposed counterparties' business. These are:

- **Long-Term credit rating:** an assessment of the capacity of the counterparty to meet its long-term financial commitments, i.e. its credit quality for long-term investments.

- **Short-Term credit rating:** an assessment of the capacity of the counterparty to meet its short-term financial commitments, i.e. its credit quality for short-term or 'specified' investments.

- **Individual rating/Financial strength rating:** an assessment of the counterparty's exposure to risk if it could not rely on any external support, i.e. its intrinsic safety and soundness. As such this rating is a view of likelihood that the counterparty will run into significant difficulties and require external support.

- **Support rating:** an assessment of the potential supporter's (i.e. the government or the counterparty's owner) propensity to support a counterparty and its ability to support it.

(N.B. these are summary definitions, each agency publishes fuller definitions of each of its ratings)

e) The table below shows which ratings each agency provides and gives the range of ratings given:

	Long-Term credit rating	Short-Term credit rating	Individual rating/Financial strength rating	Support rating
Fitch	Yes (AAA – D)	Yes (F1 – D)	Yes (A – F)	Yes (1 – 5)
Moody's	Yes (Aaa – C)	Yes (P-1 – P-3)	Yes (A – E)	
Standard & Poor's	Yes (AAA – CC)	Yes (A-1 – C)		

f) The agencies base their credit ratings on five main areas of fundamental analysis: capital adequacy, asset quality, management quality, earnings and profitability, funding and liquidity. These are mainly based on quantitative information which relate to past performance and, therefore, lack a forward looking perspective. Therefore, qualitative information is also taken into account.

g) Hence, the credit ratings are essentially opinions of credit worthiness, albeit that they are based on the analysis of a substantial amount of information and analysis and considerable knowledge and experience of the finance industry.

4.4 Wyre Forest District Council's Treasury Management Regime

a) Each year the Council makes two reports on Treasury Management to Members: The Prudential System of Local Government Finance and the Treasury Management Policy and Strategy Report in February and an Annual Report and Investment Strategy in August/September.

b) The Prudential System of Local Government Finance and the Treasury Management Policy and Strategy Report includes a Treasury Management Strategy covering the next three financial years, an Investment Counterparty and Liquidity Framework, an Investment Strategy for the next three financial years, and the Treasury Management Prudential Indicators and Limits on Activity. Appendix 6, entitled Approved Organisations for Investments, gives the credit rating thresholds for potential counterparties of the Council and other limits for investing the Council's money (e.g. the maximum amount to be invested with any one institution). Once agreed by Members it is Appendix 6, in particular, which governs the Council's decisions to invest.

c) The Annual Report and Investment Strategy in August/September reports on performance, including rates of interest obtained. It also includes a brief analysis of the current economic climate. If appropriate, revised credit rating thresholds are also included.

d) The Council employs a firm of Treasury Management Advisers to advise on an appropriate strategy and policy (reviewing the reports to Members) and who also provide a counterparty list for the Council compiled according to the policy and thresholds approved by Members in these two reports.

e) Day to day Treasury Management is the responsibility of the Head of Financial Services who holds regular Treasury Management meetings of all relevant staff involved in Treasury Management for the purpose of making the major investment decisions and of ensuring that the Council's other investments (e.g. of the smaller short-term balances in the Council's bank account) are controlled in accordance with the Council's strategy and policy. These meetings are minuted.

f) Detailed records are kept of all Treasury Management activity, including proofs of investment, copies of all communications, usually faxes, relating to investments placed, interest rates and amounts due, redemption dates, etc. and all investments are closely monitored.

5. The Icelandic Investments: Analysis and Recommendations

5.1 Icelandic Banks

a) The concurrent collapse of a number of banks within the economy of one Western nation is unprecedented (see 3.1 above). Treasury Management

policies usually include limits on the amount of money that can be invested with any one institution which is deemed sufficient to spread an organisations' risk. However, in this case this policy was not effective as the (unredeemed) investments were placed with three institutions, all of them Icelandic.

Recommendation: that the Council places an agreed limit on the amount of money it will invest with the institutions of any one national economy (either parent banks or their subsidiaries) except the British economy.

5.2 Counterparty Credit Ratings: Lowest Common Denominator (LCD)

a) Historically the Council has received, via its Treasury Management advisers (TMA), the credit ratings issued by all three agencies but has based its definition of acceptable ratings on those given by Fitch (as the most comprehensive, providing 4 ratings – see 4.3e above). A counterparty had to achieve the minimum or better in all four areas in order to be included on the counterparty list, i.e. it was not just the short-term credit rating that was considered when a short-term investment was to be made. Hence, the ratings for financial strength and likelihood of support were already taken into consideration. (This was not the case with public bodies – see 6.2a below).

b) During 2007 Moody's changed its method of calculating credit ratings which had the effect of raising the credit ratings of a number of institutions. In response to this the Council's TMA advised the Council to adopt the Lowest Common Denominator methodology. This meant taking notice of the ratings issued by all three agencies and removing a counterparty from the Council's list if any of the agencies rated it below the minimum acceptable credit ratings (still taking all credit ratings into account). This would ensure that the Council did not rely on the credit ratings issued by one agency which might be unusually high. The TMA also advised how this could be achieved when the three agencies use different rating scales (e.g. for short-term credit ratings – see table above which shows the varied scales used). This appears to be good advice as, in effect, it broadens the range of opinions of credit worthiness that are taken into account before making a decision to invest.

c) The Council decided to adopt this advice and the first counterparty list based on the LCD method was issued by the TMA on 4th September 2007. Members were informed of the new method and approved its adoption in a report to Cabinet on 27th September 2007.

d) However, the new LCD methodology has not taken account of an absence of credit ratings from an agency, i.e. it has been operated on the basis of credit ratings given, even where only one agency has given a credit rating, thus negating the advantage of a broad range of opinion. It is unclear why ratings are not awarded by an agency in any particular case.

e) None of the Icelandic banks had credit ratings from all three agencies at the time that the (unredeemed) investments were made. None was rated by Standard & Poor's. Moody's had only rated Landsbanki (not Heritable or Kaupthing). Hence, only Fitch had given a credit rating for all three Icelandic banks used. (However, those ratings that were given were within the Council's agreed thresholds.)

f) The importance of ensuring that potential counterparties are rated by all three credit rating agencies is illustrated by the example of Glitnir, another Icelandic bank that the council has invested with in the past but had no outstanding investments with at the time of the collapse. Glitnir was rated by all three credit rating agencies. However, the introduction of the LCD method in September 2007 resulted in Glitnir being removed from the counterparty list on the basis of a low credit rating from Standard & Poor's. At this time Landsbanki had exactly the same credit ratings as Glitnir from Fitch and Moody's but no rating at all from Standard & Poor's, hence Landsbanki remained in the Council's counterparty list. The (unredeemed) investment with Landsbanki was made less than two months later.

Recommendation: that the Council changes its Treasury Management policy to ensure that all of its counterparties are rated by all three credit rating agencies and that it continues to use lowest common denominator as the basis for admittance to the Council's counterparty list.

5.3 Counterparty Credit Ratings: Changes Threshold Credit Ratings

a) In 2004 the minimum acceptable credit ratings from Fitch were:

Short-term	F1 and F1+
Long-term	A+ and better
Individual	B/C and better
Support	3

b) In a report approved by Cabinet in February 2006 the threshold long-term rating was reduced to 'A'. This was based on advice from the TMA, following the appointment of the Co-Operative Bank as the Council's bank. They were rated at 'A', i.e. below the Council's then current threshold of 'A+'. Hence, the TMA advised the Council to:

"change the long term criteria from A+ to A as we feel that this is too stringent a criteria for you to use. .... Given the sort of deals (both time and size) it seems appropriate for you to use counterparties who have an "A" long term rating. The definition for the category "A" (which includes A+, A and A-) shows these organisations to be of a "high" credit quality and research also shows that those counterparties with an A (and even A-) rating will all have a short term rating of at least F1 (which itself is the criteria you use for short term ratings). .... All Council's wish to deal with the maximum amount of counterparties within an appropriate risk environment and at present we feel that you are being too stringent on yourselves and the slight change will raise the Council's ability to invest funds without unduly altering its overall risk profile."

c) In a report approved by Cabinet in September 2006 the minimum acceptable long-term rating was reduced to 'A-' (possibly on the basis of the TMA's claim that an 'A' rating included 'A-' as well).

Fitch's definition of a Long-Term 'A' rating is:

"High credit quality. 'A' ratings denote expectations of low credit risk. The capacity for payment of financial commitments is considered strong. *This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings" (my italics).* (Fitch also states: "the modifiers "+" or "-" may be appended to a rating to denote relative status within major rating categories.")

d) Also in the report of September 2006 the minimum acceptable individual rating was reduced to 'C'. The reason for this change is unclear.

Fitch's definition of an Individual 'C' rating is:

"An adequate bank, which, however, possesses one or more troublesome aspects. *There may be some concerns regarding its profitability and balance sheet integrity, franchise, management, operating environment or prospects" (my italics).*

e) At the time the (unredeemed) investments were made with the various Icelandic banks their ratings from Fitch in these two areas were:

Landsbanki 'A' and 'C',
Heritable 'A' and 'C',
Kaupthing 'A' and 'B/C'.

f) Hence, all three banks were within the reduced credit rating categories at the time the (unredeemed) investments were made. The definitions of these credit ratings indicated that there was some risk in investing with these counterparties, particularly in a period of economic downturn.

g) The subsequent collapse of the Icelandic banks has demonstrated that the caution expressed in these two credit rating definitions was fully justified.

h) However, it should be noted that all three Icelandic banks used by the Council for the three (unredeemed) short-term investments at the time the investments were placed had a short-term credit rating from Fitch of F1, the top rating, which is defined as:

"Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments; may have an added '+' to denote any exceptionally strong credit feature."

Recommendation: that the Council reviews and increases the minimum acceptable credit ratings for potential counterparties, taking detailed note of the definitions of each of the credit ratings, and continues to ensure that all credit ratings are used, not just the rating for the type of investment to be made.

N.B. In the current economic climate, with many financial institutions struggling, increasing the thresholds may be difficult but the recommendation should be implemented as soon as practically possible. In the meantime it may be appropriate to adopt a policy of only investing with the top rated institutions, e.g. the top ten or twenty.

On 23rd October 2008 Cabinet agreed a recommendation: "that for the remainder of 2008/09 investments are only placed with UK Banks and Building Societies which are rated in the Upper Limit Category, i.e. those with F1+/AA- rating, along with the UK Government and other Local Authorities. The only exception being small balances of less that £100,000 which are invested within the Council's own bank's Business Premium Account." This has given a counterparty list of 7 organisations (plus the Co-op Bank).

5.4 Counterparty Credit Ratings: Changes in Treasury Management Policy

a) There is no evidence in the Cabinet reports or the minutes that the changes to the minimum acceptable credit ratings for the Council's counterparty list outlined at 5.2 b), c) and d) above were pointed out to Members or reasons for the changes given. Hence, although the new criteria were approved, Members may not have been aware that they had changed since the previous approval.

b) Further, there is no evidence that Members were given copies of the credit rating definitions for reference when being asked to approve the criteria for compiling the counterparty list. Hence, there is no evidence that Members had sufficient information on which to base their approval of the counterparty criteria.

Recommendation: That all changes in policy are reported to Members with explanations, including changes in the counterparty thresholds, and details of the rating definitions are provided for reference.

5.5 Counterparty Credit Ratings: Subsidiaries

a) Landsbanki was rightly removed from the Council's counterparty list on 28th February 2008 on the basis of a financial strength rating of 'C-' from Moody's, below the Council's threshold of 'C' (i.e. after the unredeemed investment had been made with Landsbanki).

b) However, Landsbanki's UK subsidiary, Heritable, was unaffected by this change, its credit ratings remained within the Council's thresholds and the bank remained on the Council's counterparty list.

c) Therefore, an investment of £1million was placed with Heritable on 2nd April 2008.

d) The assets of Heritable were frozen by the UK government to prevent its assets being used to shore up Landsbanki and the Icelandic banking sector at the expense of its UK investors and administrators were appointed for Heritable on 7th October 2008.

e) Hence, subsidiaries represent a significant additional investment risk which is not necessarily reflected in the support rating allocated to them.

Recommendation: That consideration is given to a more stringent policy for investment with subsidiaries which takes account of the credit ratings awarded

to the parent body. As a minimum, both the parent and its subsidiary should have credit ratings within the Council's thresholds before an investment will be placed with the subsidiary.

N.B. It has been reported through the Local Government Association that there is a parent company guarantee in place between Landsbanki and Heritable and if there are sufficient assets from the receivership of Landsbanki these will be used to support Heritable's creditors.

5.6 Counterparty Credit Ratings: Ratings Watches

a) The credit rating agencies issue warnings when it is likely that the credit rating for an institution will change: if the credit rating is likely to go up a positive rating watch is issued and if the credit rating is likely to go down a negative rating watch is issued.

b) Credit rating agencies aim for rating stability. This means that credit ratings tend to be changed by only one rating level at a time in order to avoid rating reversals. It also means that rating agencies tend to respond only to the perceived long-term components of changes in credit quality or credit worthiness. Hence a negative rating watch is likely to mean that the credit rating will be reduced downwards by one level.

c) On 1st April 2008 negative rating watches were issued for both Heritable and Kaupthing. Notification was received from the Council's TMA less than an hour after the Council had made its commitments to invest with both banks on 1st April but before the start date for the investments on 2nd April – the question of advance investments is further considered at 5.10 below. It is unclear how long it took for the warning to be received by the Council after it was issued by the credit rating agency.

d) At this time the negative rating watches did not have the effect of removing the two banks from the Council's counterparty list as no change to the credit ratings was actually made.

e) However, as the then current ratings for these two banks were at or near the threshold credit ratings set by the Council the downgrading was likely to result in the removal of both banks from the Council's counterparty list.

Recommendations:

- that the Council has a formal policy for taking account of negative rating watches relating to its listed counterparties, e.g. not investing with any counterparty where the likely change in credit rating (assumed to be by one rating level unless other information available suggests a greater reduction) will remove it from the Council's counterparty list;

- that, where a substantial investment is to be made by the Council – appropriate threshold to be decided – the Council considers making use of the websites of the TMA and of the credit rating agencies to ensure that they have the most up to date information on the creditworthiness of their

proposed counterparty (and does not rely solely on e-mail communications from the TMA which will necessarily involve at least a short delay in the communication of information).

N.B. Out of the current 7 organisations on the Council's counterparty (excluding the Co-op Bank) list 4 are subject to negative rating watches.

5.7 Counterparty Credit Ratings: Reporting the Counterparty List

a) There is no evidence that Members who are asked to approve the criteria for the counterparty list have ever seen the resulting actual counterparty list. A sight of the list would give Members a greater understanding of what they are approving and give them the chance to ask questions about the counterparty list – which may need to be researched and responded to at a later date.

Recommendation: That the actual counterparty list is reported to Members once or twice a year as at a particular date and making it clear that it is under constant review (this will need to be during the exempt part of the meeting). This could most usefully be done at the same time as the counterparty criteria are being considered for approval by Cabinet and Council, e.g. in February when 'The Treasury Management Policy and Strategy Report' is presented and in September when the 'Report on Treasury Management Service and Actual Prudential Indicators' is presented.

5.8 Counterparty Credit Ratings: Compiling the Counterparty List

a) The Council's TMA provide the counterparty list in accordance with their interpretation of the Council's criteria. However, there is evidence that the Council should not accept this list at face value (in addition to the lack of credit ratings from some agencies for some counterparties discussed at 5.1 above).

b) In January 2006 it was noted that some of the investment limits recorded against the counterparties were incorrect. This was discussed with the TMA and a revised version was promised;

c) The counterparty list for 6th November 2006 (before the LCD method, described at 4.2 above, had been adopted) included:
- a bank with a support rating of 5 from Fitch which should not therefore have been included;
- a building society with a long term rating of BBB+ from Standard & Poor's which is below the Council's threshold rating criteria but may have been included on the basis of assets (see e)-g) below);
- a bank that had been given NR (no rating) by Fitch and, arguably, should not have been included, or should have been queried at least;
- three banks which were missing one of the ratings from one of the credit rating agencies, in one case this was a Fitch rating, but their inclusion was not queried.

d) The counterparty list of 4th September 2007, the first compiled using the LCD method, included:

- four banks that were missing one of the ratings from one of the credit rating agencies, again there is no evidence that their inclusion was queried;
- the building society rated by all three agencies but including a long term rating of BBB+ from Standard & Poor's that was below the rating threshold.

e) In January 2006 the Council's TMA advised the Council to use credit ratings for assessing the credit worthiness of building societies, rather than the level of assets that had been used up to that date:

"I . . . . would suggest that rather than separating out banks and building societies you use ratings to determine the limits (where applicable). In this way both types of institution would be treated on a similar basis and this method would be much more robust under scrutiny if ever there was any questions. The difficulty here is that the current limits, especially those applied to building societies with assets over £2bn is quite high given their ratings. ...."

f) After some consideration it was decided to accept this advice and the change was reported to Members with an explanation in September 2006. However, this was not implemented.

g) The counterparty lists from the Council's TMA continued to include Building Societies on the basis of assets. The Treasury Management Strategy of February 2007 stated that assets would continue to be the basis for assessing Building Societies but Appendix 6, which set out the Council's credit rating thresholds, stated that "the council will use banks and building societies which have at least the following Fitch or equivalent ratings . . . .". This inconsistency was not queried during the consultation stage of this document (including examination by the TMA) and the change to using credit ratings for Building Societies was not implemented thereafter.

Recommendations:

- that counterparty lists are examined for compliance with all criteria when they are received - for which an up to date list of the policies influencing the counterparty list will need to be kept, including the most recently approved threshold credit ratings, the decision to use ratings for Building Societies, the policy with regard to subsidiaries, etc. – with a second person looking at the list when it is received as an independent review, with any unusual entries or other queries being raised and addressed immediately. Both the examination and review to be evidenced by signatures;

- that the policy of using credit ratings for Building Societies is implemented, as intended and reported in September 2006, in order to help maximise the security of the Council's remaining funds.

5.9 <u>Advice from the Council's Treasury Management Advisers</u>

a) The Council receives a periodic bulletin from their Treasury Management advisers which contains general news and advice.

b) In the wake of Moody's reassessment of its credit ratings and the concerns that it raised within the industry the TMA issued general advice to its clients to

focus more closely on the financial strength ratings. Although this publication was received there is no clear evidence that this advice was noted and considered. Certainly, the Council's individual/financial strength threshold remained at 'C' – the rating which applied to two of the three Icelandic Banks at the time the (unredeemed) investments were placed.

Recommendation: that all communications with or received from the Council's Treasury Management advisers are discussed/reviewed at Treasury Management meetings and listed in the minutes with decisions/responses recorded. This should include the counterparty lists.

5.10 Advance Investment Deals

a) In November 2007 the Council started asking its advisers about the possibility of making forward deals, the advantages and the accounting treatment required. The main advantage is that, in the right economic climate, a better rate of interest can be obtained for an advance commitment.

b) The two investments made in April 2008 with Heritable and Kaupthing were committed one day in advance of the start date of the investment, i.e. they were committed on 1st April with the investment commencing on 2nd April.

c) The effect of this was to prevent the Council acting on the negative rating watches received less than an hour after the Council had entered into the commitment to invest (re ratings watches see 5.6 above). It is not certain that the two warnings would have resulted in the investments being placed elsewhere as the downgrading of the credit ratings had not yet occurred, but the advance commitment meant that the option to invest elsewhere was not available.

Recommendation: that decisions to make advance investment deals are carefully considered and the reasons fully recorded and that decisions take account of the current economic climate, e.g. advance deals should be generally avoided during a period of economic decline but could be advantageous during a period of economic buoyancy.

5.11 Appointment of the Council's Treasury Management Advisers

a) The Council has been using the same Treasury Management advisers since at least 2001. The current contract expires at the end of August 2010. Hence, the same advisers will have been used for nine years. Over such a long period the relationship between the Council and its advisers may have become too comfortable. It is good practice for contracts to be retendered every three to five years.

b) In the light of the Council's potential losses to the Icelandic banks, and some of the findings and recommendations outlined above, it may be appropriate to rethink the Council's requirements from its Treasury Management advisers and to retender the contract for September 2010 onwards.

c) There is also advantage to be gained from using a variety of advisory input. This would enable the Council to obtain ideas and good practice from a variety of sources.

Recommendation: that the opportunity is taken to revise the specification for the Council's Treasury Management advisers and to retender the contract for the period starting September 2010 when the current contract will have expired.

5.12 Other Sources of Advice/Intelligence

a) Another good source of advice and intelligence on treasury management practice is neighbouring local authorities who all carry out some treasury management activity.

Recommendation: that the Council is proactive in establishing and participating in a Local Authority Treasury Management group for Herefordshire and Worcestershire (subject to sufficient interest from the other local authorities).

5.13 Economic Changes

a) The Council's potential losses and the problems within the financial sector generally are the result of a decline in many of the major economies.

b) The recommendations made above are all extremely cautious. It is likely that when the economy improves the Council will relax some of its policies – this is not recommended but the temptation is likely to be considerable. Hence,

Recommended: that there is much greater sensitivity to general economic performance built into the Council's Treasury Management Strategy in future so that, for example, the first signs of an economic downturn will trigger a review of credit rating thresholds and ensure that they are tightened.

6. Context/Comparisons

6.1 Comparison of Credit Ratings and Defaults

a) In their submission to the Securities and Exchange Commission in the US in 2002 (see under 'Sources' below) Standard and Poor's demonstrated the strong correlation between initial ratings assigned by them and the likelihood of default. The evidence given was an analysis of the percentage of defaulting institutions initially rated in each of their credit rating categories over the previous fifteen years. This showed that even in the top rated category of 'AAA' 0.52% of institutions defaulted. In the category of 'A' the percentage of defaults was 2.32%.

b) This illustrates both the usefulness of credit ratings and the hazards of trying to predict future performance, which cannot be done with absolute certainty even by specialists. (See also 4.3 above where it is shown that credit ratings are, in essence, opinions of future creditworthiness based mainly on past performance and current position).

6.2 Comparisons with Other Bodies

a) A report into the Audit Commission's investments with Icelandic banks shows that their investment with Landsbanki was made on 29th May 2008, three months after the bank had been removed from the Council's counterparty list. The investment was based on the short-term credit rating of F1 from Fitch without taking account of any of the other credit ratings issued by Fitch or the other agencies.

This demonstrates that the Council's Treasury Management policies were more stringent than those of the Audit Commission although they did not prevent the Council from having investments with Icelandic banks at the time of their collapse.

b) Comparison of the Council's Treasury Management Strategy with those of other Councils with the same Treasury Management advisers suggest that the format of the strategy and the advice as to acceptable credit ratings were similar, i.e. the Council was given similar advice to the advisers' other clients.

c) North East Lincolnshire Council, with the same Treasury Management advisers, made some of its investments in the Icelandic banks in October 2008, the month in which they collapsed. A report into the £7million potential losses stated that

"If the council had understood that . . . . it was not receiving direct notifications regarding the status of Icelandic banks, then it is conceivable that the investments, particularly those placed in October 2008, would not have been made".

Again, this demonstrates that the Council's Treasury Management activity compares favourably with some other Councils.

7. Conclusion

7.1 This analysis of the circumstances surrounding the Councils Icelandic investments and the broader context within which they took place suggests that there was considerable complacency within the Treasury Management sector generally with an underlying assumption that money was safe in banks. Even the experience in America and the run on Northern Rock did not shake this conviction. Hence, a substantial number of local authorities and other government institutions were surprised by the very sudden collapse of the Icelandic banks and have potentially lost money.

7.2 In consequence, it is concluded that no Council officers were to blame for the losses at Wyre Forest District Council. The Head of Finance changed between the two investment dates, hence, one officer was not responsible for authorising all of the investments. The Council was making use of the advice available from both its Treasury Management advisers and the credit rating agencies, all acknowledged as experts in the field of Treasury Management. As indicated above, hindsight has suggested that some aspects of this advice could have been questioned. However, the difficulty of predicting future performance has also been highlighted on the evidence of one of the credit rating agencies. Hence, investment will always involve a certain amount of risk. The recommendations made in this report are aimed at reducing that risk as far as possible but they cannot totally negate the risk.

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